



RESPONSE TO SUBMISSIONS

Revisions to the capital framework for
authorised deposit-taking institutions

12 June 2019

Disclaimer Text

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Executive summary

Regulatory capital requirements are designed to broadly reflect the risks in a financial institution's business, and ensure that it holds a minimum amount of capital to absorb potential losses. While Australian authorised deposit-taking institutions (ADIs) have historically been well capitalised, the Financial System Inquiry nonetheless recommended that APRA 'set capital standards such that Australian ADI capital ratios are unquestionably strong'.¹ In response to this recommendation, APRA determined that it would need to strengthen capital requirements by approximately 150 basis points for ADIs using the internal ratings-based (IRB) approach (IRB ADIs) and by 50 basis points for ADIs using the standardised approach.²

In February 2018, APRA released a discussion paper that proposed a number of revisions to the capital framework for ADIs in order to give effect to the increased capital requirements for unquestionably strong and to also incorporate the amendments from the recently finalised Basel III reforms.³ That discussion paper set out APRA's initial proposals on the revised credit risk, operational risk and market risk frameworks, the adoption of a capital floor and proposals for a simplified framework for smaller, less complex ADIs. APRA released a complementary discussion paper in August 2018 on improving the transparency, comparability and flexibility of the capital framework, which focused on the presentation of capital ratios.

The proposals in this response paper and accompanying draft prudential standards aim to progress APRA's primary objectives of implementing Basel III and increasing capital requirements to meet the unquestionably strong benchmarks. More broadly, APRA's reform of the ADI capital framework also seeks to achieve a number of other objectives, including:

- addressing the structural concentration in residential mortgages, including embedding improved serviceability assessments in the capital framework and targeting higher risk residential mortgages;
- ensuring appropriate relative capital outcomes between the IRB and standardised approaches; and
- improving the transparency, comparability and flexibility of the capital framework, without introducing undue complexity.

¹ Financial System Inquiry, *Final Report* (November 2014), recommendation 1, <<http://fsi.gov.au/publications/final-report/chapter-1/capital-levels/>>.

² APRA, *Strengthening banking system resilience – establishing unquestionably strong capital ratios* (Information Paper, July 2017) <https://www.apra.gov.au/sites/default/files/Unquestionably%2520Strong%2520Information%2520Paper_0.pdf>.

³ Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms* (December 2017) <<https://www.bis.org/bcbs/publ/d424.htm>>.

Given the ambitious nature of these objectives, and the extent to which they could impact different types of ADIs, it is inevitable that certain trade-offs will be required. APRA will continue to balance its stated objectives in order to achieve an appropriate final framework.

This response paper progresses key elements of the proposals relating to residential mortgages, the standardised approaches to credit risk and operational risk, and the simplified framework. Proposals on other amendments to the IRB approach, the interest rate risk in the banking book framework and improvements to the transparency, comparability and flexibility of the ADI capital framework, will be subject to consultation later this year.

While the results of the first quantitative impact study (QIS) have been used to calibrate the risk weights for credit exposures set out in this response paper and the accompanying draft prudential standards, these proposed risk weights should not be viewed as definitive. Rather, they are intended to be indicative of the quantum of changes in particular asset classes, and may be subject to recalibration to ensure consistency with the unquestionably strong capital targets. Given the need for better data to refine the calibration, APRA will be concurrently undertaking a second QIS as part of this response package, and will be asking a larger sample of ADIs to participate. One further round of consultation is expected to be undertaken on the draft prudential standard on the standardised approach to credit risk, accompanying this response paper. There will also likely be further rounds of consultation on the remaining capital adequacy standards, including the IRB approach, impacted by the Basel III reforms.

In addition, APRA's ultimate approach with respect to transparency, comparability and flexibility of the capital framework may affect the specification and presentation of risk weights — although not necessarily the level of capital requirements — across different types of exposures. As a result, APRA encourages submissions to focus on the broad principles and relative capital requirements across exposure types indicated by these proposals, rather than specific proposed risk weights.

APRA is proposing to align the implementation of the revised capital standards with the Basel Committee's internationally agreed implementation date for Basel III of 1 January 2022.⁴ APRA is, however, considering an earlier implementation date for the revised operational risk capital requirements for ADIs currently using an advanced measurement approach for operational risk.

⁴ APRA, 'APRA responds to submissions on ADI leverage ratio, and extends timeline for broader capital framework reforms' (Media Release, 27 November 2018) <<https://www.apra.gov.au/media-centre/media-releases/apra-responds-submissions-adi-leverage-ratio-and-extends-timeline>>.

Glossary

ADC	Land acquisition, development and construction
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 112	<i>Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk</i>
APS 113	<i>Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk</i>
APS 115	<i>Prudential Standard APS 115 Capital Adequacy: Standardised Measurement Approach to Operational Risk</i>
Basel III framework	<p>A series of reforms to the Basel capital framework following the global financial crisis that commenced with the Basel Committee on Banking Supervision's <i>Basel III: A global regulatory framework for more resilient banks and banking systems</i> (December 2010, revised June 2011) and includes the following reforms:</p> <ul style="list-style-type: none"> • <i>Basel III: Finalising post-crisis reforms</i> (December 2017) which includes revisions to the frameworks for credit risk, credit valuation risk and operational risk, and introduces a floor on risk-weighted assets using the standardised approaches and a non-risk-based minimum leverage requirement; • <i>Minimum capital requirements for market risk</i> (January 2019); and • <i>Interest rate risk in the banking book</i> (April 2016).
Basel Committee	Basel Committee on Banking Supervision
CCF	Credit conversion factor
FSI	Financial System Inquiry
IRB ADI	An ADI that has been granted approval from APRA to adopt the internal ratings-based approach for determining its capital adequacy requirements for credit risk.
LMI	Lenders' mortgage insurance
LVR	Loan-to-valuation ratio
QIS	Quantitative Impact Study
RWA	Risk-weighted assets
SME	Small- and medium-sized enterprise
Standardised ADI	An ADI that uses the standardised approach to credit risk to determine its capital adequacy requirements.

Chapter 1 - Introduction

1.1 Background

APRA's current round of revisions to the authorised deposit-taking institution (ADI) capital framework is a large, complex initiative that has been influenced by both domestic and international developments. To date, the revisions have been undertaken through three interdependent consultation work streams:

- the quantum of capital as detailed in *Strengthening banking system resilience – establishing unquestionably strong capital ratios*;⁵
- the allocation and risk sensitivity of capital requirements as set out in *Revisions to the capital framework for authorised deposit-taking institutions*;⁶ and
- the presentation and calculation of capital ratios and minimum requirements as outlined in *Improving the transparency, comparability and flexibility of the ADI capital framework*.⁷

This consultation formally brings together the first two work streams for:

- the standardised approach to credit risk;
- the standardised approach to operational risk; and
- the internal ratings-based (IRB) approach for residential mortgage exposures.

The transparency, comparability and flexibility work stream will be the subject of further consultation later this year, together with other elements of the IRB approach to credit risk and the interest rate risk in the banking book (IRRBB) framework. Importantly, the outcome of these consultations, in particular with respect to the presentation and calculation of capital ratios and requirements, could result in further changes to the proposed risk weights set out in the accompanying draft prudential standards.

⁵ APRA, *Strengthening banking system resilience – establishing unquestionably strong capital ratios* (Information Paper, July 2017) <https://www.apra.gov.au/sites/default/files/Unquestionably%2520Strong%2520Information%2520Paper_0.pdf>.

⁶ APRA, *Revisions to the capital framework for authorised deposit-taking institutions* (Discussion Paper, February 2018) <<https://www.apra.gov.au/implementing-basel-iii-capital-reforms-australia>>.

⁷ APRA, *Improving the transparency, comparability and flexibility of the ADI capital framework* (Discussion Paper, August 2018) <<https://www.apra.gov.au/improving-transparency-comparability-and-flexibility-authorised-deposit-taking-institution-capital>>.

1.2 Objectives

APRA's primary objectives in proposing revisions to the ADI capital framework are:

- implementing the Basel III reforms in a manner that is at least equivalent to the minimums set out in the Basel III framework; and
- achieving the increased minimum capital requirements necessary to meet the unquestionably strong benchmarks (150 basis points for ADIs that use the IRB approach (IRB ADIs) and 50 basis points for ADIs that use the standardised approach).

More broadly, APRA is seeking to achieve a number of other objectives, including:

- addressing the structural concentration in residential mortgages, including embedding improved serviceability assessments in the capital framework and targeting higher risk residential mortgages;
- ensuring appropriate relative capital outcomes between the IRB and standardised approaches, both on an overall basis and for the residential mortgage portfolio, so as not to create unwarranted competitive distortions; and
- improving the transparency, comparability and flexibility of the ADI capital framework, without introducing undue complexity.

Given the ambitious nature of these objectives, and the extent to which they may impact different types of ADIs, it is inevitable that certain trade-offs will be required to be made. Consideration of these objectives also reflects APRA's mandate to balance financial safety with competition and efficiency considerations.

1.3 Calibration

APRA continues to target an overall increase in capital requirements of 150 basis points for IRB ADIs and 50 basis points for standardised ADIs. However, as these benchmarks represent an *average* targeted outcome across the industry as a whole, results will inevitably vary across different ADIs depending on their portfolio composition and risk profile.

The proposed risk weights included in this response paper and accompanying draft prudential standards for credit risk, while informed by the data collected as part of the first quantitative impact study (QIS), are not final proposals. Rather, they are intended to be indicative of the portfolios where APRA considers that higher or lower capital requirements are likely to be required, having regards to the overall objectives set out above.

Given the need for additional data to inform the final calibration, APRA will be undertaking a second QIS as part of this response package, and will be asking a larger sample of ADIs to participate. APRA will use the data collected to refine not only its risk weight proposals, but also to ensure that the framework as a whole is appropriately calibrated to meet the unquestionably strong benchmarks.

1.4 Submissions received

The February 2018 discussion paper on *Revisions to the capital framework for authorised deposit-taking institutions* outlined APRA's initial proposals for implementing the final Basel III reforms and meeting the objectives of unquestionably strong capital ratios. Specifically, it set out proposals relating to:

- credit risk, specifically the treatment of residential mortgage exposures and other revisions to the standardised and IRB approaches;
- operational risk, including the replacement methodology for the advanced measurement and standardised approaches;
- IRRBB;
- a simplified framework for smaller, less complex ADIs; and
- the overall approach to calibration and introduction of a capital floor.

APRA subsequently released the discussion paper *Improving the transparency, comparability and flexibility of the ADI capital framework* in August 2018. The proposals in that discussion paper complement the proposed revisions to the capital framework, by seeking to ensure that the capital strength of Australian ADIs is appropriately understood by market participants.

APRA received 18 submissions from ADIs and industry associations in response to the February 2018 discussion paper; non-confidential submissions have been published on APRA's website. This response paper sets out the main issues raised by industry, and APRA's response, in relation to residential mortgages (under both the IRB and standardised approaches), other proposed amendments to the standardised approach to credit risk, revisions to the capital treatment for operational risk and the simplified framework.

Importantly, this paper does not respond to APRA's August 2018 consultation on improving the transparency, comparability and flexibility of the ADI capital framework. However, given those proposals focus primarily on the presentation of capital ratios and requirements, APRA's ultimate decisions on those proposals are not likely to materially alter either the quantum of overall capital requirements or the allocation for specific asset classes. APRA will respond to the issues raised regarding the other changes to the IRB approach and improving the transparency, comparability and flexibility of the ADI capital framework when it consults on the relevant prudential standards in the second half of this year.

1.5 Draft prudential standards

The initial feedback from industry has been considered in drafting the revised prudential standards. Accompanying this response paper are draft versions of:

- *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112);

- the residential mortgages extract of *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113); and
- *Prudential Standard APS 115 Capital Adequacy: Standardised Measurement Approach to Operational Risk* (APS 115).

APRA welcomes submissions on all proposals in this response paper, as well as the draft prudential standards which are available at: <www.apra.gov.au/consultations-revisions-capital-framework-authorized-deposit-taking-institutions>

1.6 Quantitative impact study and overall calibration

APRA will be conducting a second QIS as part of this response package, and will shortly contact a sample of ADIs, including a range of different-sized entities, to request participation in this exercise on a 'best endeavours' basis. ADIs may also elect to contribute data to the exercise by contacting their responsible supervisor. Individual data submitted by ADIs will remain confidential.

Chapter 2 - Credit risk: residential mortgage lending

This chapter sets out APRA's response to submissions on the treatment of residential mortgages under both the standardised and IRB approaches.

2.1 Operational requirements for standard mortgages

In the previous round of consultation, APRA signalled its intention to adopt the Basel III operational criteria for standard residential mortgages, subject to certain adjustments appropriate for Australian circumstances, including requirements relating to:

- completed property;
- legal enforceability;
- first lien;
- ability to repay;
- valuation; and
- documentation.

The Basel III framework provides national supervisors with the discretion to specify underwriting criteria for the purpose of determining a borrower's ability to repay. For this purpose, the February 2018 discussion paper proposed a number of serviceability metrics that would need to be satisfied in order for a residential mortgage loan to be classified as standard, including:

- the application of an interest rate buffer of 2 per cent and an interest rate floor of 7 per cent to new and existing debt commitments;
- for interest-only loans, an assessment of the repayment over the principal and interest period;
- a requirement for a positive net income surplus; and
- that loans must be approved within the ADI's serviceability policy.

The February 2018 discussion paper also proposed that loans with very high multiples of a borrower's income could be classified as non-standard.

Comments received

A number of respondents contended that APRA's proposed operational criteria for standard mortgages would result in a large number of residential mortgages being classified as non-

standard and subject to higher capital requirements that would not appropriately reflect the underlying risk. Comments on the specific criteria are set out below.

Completed property

Several respondents agreed with the proposal that APRA should exercise its supervisory discretion to include certain types of construction loans within the standard mortgage segment.

Ability to repay

Respondents generally did not support embedding underwriting standards in the capital framework as criteria for standard mortgages:

- One respondent submitted that setting minimum interest rate buffers and floors could become restrictive depending on the economic environment.
- Several respondents objected to the proposed requirement for positive net income surplus on the basis that it is too subjective and would vary across the industry, as it relies on definitions relating to minimum income verification and the quantum of any haircuts applied.
- A number of respondents did not support the use of a high loan-to-income multiple, opining that a debt-to-income measure is a preferable measure. One respondent noted that if this requirement were implemented, further guidance would be required on what constitutes a very high multiple of income (noting that that a higher multiple may be appropriate at higher income levels) and what qualifies as income.
- Respondents did not support the proposal that mortgages approved outside of an ADI's serviceability policy be treated as non-standard, on the basis that this approach would favour lenders with less conservative serviceability policies, and could encourage ADIs to lower their lending standards.

Valuation

Respondents recommended that APRA retain its current approach which allows property to be revalued upwards if a formal independent valuation is undertaken, rather than adopt the Basel III requirement that the value at origination be retained, unless there is a downward valuation.

Seasoning provision

Respondents requested that APRA retain the current provision in APS 112 which allows for non-standard loans to be reclassified as standard if they have been performing for a specified period of time.

Transition arrangements

A number of respondents requested that the proposed definition of non-standard residential mortgages be limited to new customers only. Alternatively, respondents suggested that for loans originated prior to the finalisation of the prudential standards, APRA could implement transitional arrangements commensurate with the average behavioural maturity of a mortgage.

APRA's response

In response to the various concerns raised by industry, APRA is proposing to more narrowly define the scope of residential mortgages that will be considered non-standard. APRA's response to the issues raised in relation to the specific criteria is set out below.

Completed property

For simplicity, the requirement that the property securing an exposure must be fully completed has been removed from the standard mortgage criteria; however, any exposure secured by property that is not fully completed will be treated as a land acquisition, development and construction (ADC) exposure (refer to section 4.1 below). Exceptions to this general requirement to treat these exposures as ADC include where the property is used for agricultural or forestry purposes, or where the loan is to an individual constructing their primary residence.

Ability to repay

APRA acknowledges that it would be difficult to ensure consistent interpretation and implementation of all serviceability metrics initially proposed in the February 2018 discussion paper. Therefore, APRA is no longer proposing to include the requirements relating to the use of a high loan-to-income multiple and that mortgages must be originated within an ADI's serviceability policy. While APRA does not intend to explicitly link these measures to the capital treatment of residential mortgages, it does expect that ADIs would include appropriate limits on this type of lending in their serviceability policies, consistent with the guidance included in *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223).

Consistent with the intent of the Basel III reforms that national supervisors ensure banks put in place appropriate underwriting policies, APRA proposes that an ADI must, prior to loan approval, appropriately document, assess and verify the ability of a borrower to meet their repayment obligations. This assessment must, at a minimum, include:

- the application of an interest rate buffer of at least 2.5 per cent;⁸
- the application of the buffer to both new and existing debt, recognising that for certain types of debt, higher buffers may be appropriate; and
- for interest-only loans, an assessment of the ability of the borrower to repay over the principal and interest period.

Where an ADI's assessment does not result in a positive determination of a borrower's ability to meet their repayment obligations, the ADI would be required to classify the residential mortgage exposure as non-standard.

⁸ The level of the buffer will be determined in accordance with APRA's consultation on revisions to *Prudential Practice Guide APG 223 Residential Mortgage Lending* <<https://www.apra.gov.au/media-centre/media-releases/apra-proposes-amending-guidance-mortgage-lending>>

As these measures reflect APRA's recent supervisory work to improve mortgage underwriting standards, most ADIs should already satisfy these requirements for recently originated mortgages.

Valuation

APRA proposes to allow ADIs to revalue the property securing a residential mortgage where an updated valuation is obtained as part of a new loan application process. This provision is intended to reduce incentives to churn and allow ADIs to compete for the business of their customers.

APRA also proposes to require ADIs to revalue property where an event occurs that results in a likely permanent reduction of a property's value. This proposal would replace the current provision in APS 112 that requires an ADI to revalue property when it becomes aware of a material change in the market value of property in an area or region, which has the potential to produce procyclical regulatory capital outcomes. APRA considers that the proposed risk weights are set at an appropriate level to take into account the potential for changes in property values through credit cycles.

Seasoning provision

APRA proposes to retain the current APS 112 provision which allows a non-standard residential mortgage to be reclassified as standard where it has been materially performing for at least 36 months. However, this provision will only apply to residential mortgages that do not meet serviceability criteria at origination; ADIs will not be permitted to reclassify mortgages which do not meet any of the other standard criteria as the underlying risks will not have lessened with the additional time. Additionally, ADIs would not be permitted to reclassify reverse mortgages, loans to self-managed superannuation funds (SMSFs) or shared equity mortgages as standard mortgages. APRA will continue to consider whether a time period greater than 36 months is appropriate based on default data.

Transition arrangements

APRA is proposing to allow residential mortgages originated prior to the release of final prudential standards and that are currently treated as standard mortgages, but do not meet the serviceability criteria outlined above, to be treated as standard mortgages under the new standard. However, in line with the expectations set out in APG 223 and APRA's recent supervisory work on residential mortgages, APRA expects that most new residential mortgages being written by ADIs will already meet the proposed criteria. APRA will continue to have a supervisory focus on mortgages originated outside of these minimum requirements.

All other residential mortgages that are currently designated as non-standard, as well as reverse mortgages, loans to SMSFs and shared equity mortgages, will be required to be treated as non-standard from the commencement of the revised prudential standards.

2.2 Non-standard mortgage risk weights

APRA proposed applying a flat risk weight of 100 per cent to all non-standard residential mortgages, including reverse mortgages, loans to SMSFs and shared equity mortgages.

Comments received

A number of respondents asserted that the proposed risk weight of 100 per cent for all non-standard mortgages is punitive and does not sufficiently reflect underlying risk. Respondents suggested the inclusion of a more granular risk weight schedule based on features such as loan-to-valuation ratio (LVR), or the application of multipliers to the standard mortgage risk weights to reflect identified risk factors.

A few respondents also disagreed with APRA's proposal that reverse mortgages and loans to SMSFs be treated as non-standard mortgages.

APRA's response

APRA expects that given the proposed narrower definition of non-standard mortgages, these exposures will not form a material portion of the residential mortgage portfolio of ADIs. For the purposes of simplicity and consistency, APRA does not intend to adopt a more granular risk weight treatment for non-standard mortgages; that is, APRA proposes to retain a flat risk weight of 100 per cent.

In relation to reverse mortgages, APRA is proposing to retain the current approach under APS 112 which allows for a lower risk weight to apply to those mortgages with a LVR of less than 60 per cent. IRB ADIs would also be required to apply the standardised approach to their reverse mortgage exposures. Loans to SMSFs and shared equity mortgages would be treated as non-standard under both the standardised and IRB approaches.

2.3 Segmentation by risk

Rather than adopt the Basel III concept of material dependence (i.e. the ability to service a loan materially depends on the cash flows generated by the property securing the loan), APRA proposed to segment residential mortgages into two categories — lower risk owner-occupied principal-and-interest loans, and higher risk mortgages, including investor loans, interest-only loans and loans to SMEs secured by residential property. The Basel III risk weight schedule for 'not materially dependent' mortgages would be used for the lower risk mortgages. For the higher risk mortgages, the two options proposed included adopting the Basel III 'materially dependent' risk weight schedule, or the application of a multiplier to the lower risk mortgage risk weights.

APRA also sought feedback from industry on whether exposures to individuals with a large investment portfolio (for example, more than four residential properties) should be treated as non-standard residential mortgages or as commercial property exposures.

Comments received

Respondents generally supported APRA's proposals to segment the residential mortgage portfolio into lower risk and higher risk mortgages, although two respondents noted that there is little nationwide downturn data to finely calibrate risk weights for the higher risk mortgages. Most respondents also preferred the use of a fixed risk weight schedule rather than the application of a multiplier for the higher risk mortgages category. A small number of respondents suggested that APRA incorporate additional granularity in the proposed risk weight schedule.

Most respondents also preferred that owner-occupied mortgages be defined by reference to the loan purpose rather than the underlying security.

Respondents were generally not supportive of applying a differential treatment to loans to individuals with a large investment portfolio. Several respondents commented that using the number of properties to identify large investors was not reflective of risk and would be complex to implement; an approach that considered the extent of investor reliance on the income generated by the properties to service the debt was preferred.

APRA's response

APRA is proposing to retain the lower and higher risk mortgage segmentation as proposed in the February 2018 discussion paper.

At this stage, APRA is also proposing to adopt fixed risk weight schedules for both categories, rather than applying a multiplier to owner-occupied principal-and-interest mortgage risk weights for the higher risk category. However, this approach may be reconsidered as part of APRA's work on transparency, comparability and flexibility.

APRA is proposing to amend the calibration of the fixed risk weights, in order to narrow the overall capital difference between the lower and higher risk mortgage segments. The proposed risk weights are set out in Table 1 below (the treatment of LMI is discussed in section 2.5 below) — these will be reviewed further following the second QIS exercise. Subsequent to the analysis of the QIS data, APRA may also consider making further changes to the 'other residential mortgages' segment.

Table 1. Indicative risk weights for residential mortgage exposures under the standardised approach

LVR %		RW %						
			≤ 50	≤ 60	≤ 80	≤ 90	≤ 100	> 100
Standard	Owner-occupied principal-and-interest mortgages	LMI	20	25	35	45	60	80
		No LMI				55	70	85
	Other residential mortgages	LMI	25	30	45	60	75	90
		No LMI				70	85	95
Non-standard	Reverse mortgages	50			100 ⁹			
	Other non-standard mortgages	100						

In order to avoid introducing additional complexity into the segmentation of residential mortgages, APRA proposes not to introduce additional LVR bands or new tiers of risk weights.

Regarding the definition of owner-occupied loans, APRA proposes to adopt loan purpose as the basis of classification. This is consistent with the approach applied in *Reporting Standard ARS 223.0 Residential Mortgage Lending* and the economic and financial statistics reporting collection.

To avoid introducing additional complexity into the standardised approach, APRA no longer proposes to include a large investor category in APS 112. These exposures will be captured as part of the higher risk mortgage category. APRA expects that the serviceability policies of ADIs include the application of appropriate haircuts where the borrower depends on the income generated by the property, or other properties, to repay the mortgage.

2.4 The IRB approach

APRA proposed four main revisions to the IRB treatment of residential mortgages, including:

- increased capital requirements for residential mortgages to be implemented through two separate risk-weight functions;

⁹ Reverse mortgages must be treated as defaulted exposures if the LVR exceeds 100 per cent.

- amendments to the correlation factor to depend on the probability of default (PD);
- a reduction in the minimum loss given default (LGD) floor from 20 per cent to 10 per cent for ADIs that have an APRA-approved LGD model; and
- capital requirements for non-standard mortgages to be calculated using the standardised approach.

APRA also highlighted the potential for additional risk-weighted assets (RWA) overlays to be applied as part of the final IRB calibration, consistent with the objectives of achieving unquestionably strong capital and also responding to recommendation 2 of the Financial System Inquiry on narrowing the difference between average mortgage risk weights under the IRB and standardised approaches.

Comments received

Respondents generally preferred the use of a single asset correlation function for residential mortgages. Several respondents were of the view that higher risk lending can be more effectively managed through changes to the PD and LGD estimates in the IRB model instead of through APRA's proposed changes to the IRB risk-weight functions, given that risk factors proven to result in higher default or loss rates are already included in IRB models.

Regarding the proposal to make the correlation curve sensitive to PD, two respondents noted that while this would dampen procyclicality, it would also penalise high quality mortgages disproportionately relative to low quality mortgages.

Respondents were supportive of the development of mortgage downturn LGD models and the corresponding reduction of the LGD floor to 10 per cent for those ADIs with APRA-approved models. One respondent recommended that the LMI pay-out ratio and collateral haircuts should be standardised as part of this process in order to improve consistency across ADIs.

Respondents generally did not support the proposal to require IRB ADIs to use the standardised risk weight of 100 per cent for all non-standard mortgages.

APRA's response

In response to industry's feedback, APRA is now proposing to implement a simpler method for calculating the capital requirements for residential mortgages. Rather than introducing two correlation functions, APRA is proposing to revert to the Basel III correlation of 15 per cent and achieving the targeted calibration through the application of multipliers to RWA. Indicative multipliers for this purpose are included in Table 2 below.

Table 2. Indicative multipliers under the IRB approach

Owner-occupied, principal-and-interest mortgages	1.5 x
Other residential mortgages	2 x

Similar to the separate risk-weight schedules under the standardised proposals, two different multipliers will be applied to owner-occupied principal-and-interest mortgages and

other residential mortgages. These multipliers have been calibrated to target increased capital for residential mortgages, in line with the objectives of unquestionably strong. APRA considers that this approach is simpler to implement, and may also allow for APRA's conservatism relative to global practices to be more readily transparent.

Given APRA is now proposing to adopt the Basel correlation function for the higher and lower risk segments of the standard residential mortgage portfolio, and achieve the required calibration through the application of multipliers, the correlation factor will not vary with PD under this approach.

APRA is also proposing to simplify the application of the current 20 per cent LGD floor where APRA has not approved an ADI to use its own estimates. A flat 20 per cent LGD estimate will be applied to all residential mortgage exposures in this case.

As set out under section 2.2, APRA has proposed narrowing the definition of a non-standard mortgage and therefore considers that the application of a flat 100 per cent risk weight for these exposures remains appropriate under both the standardised and IRB approaches.

2.5 Lenders' mortgage insurance

The February 2018 discussion paper did not include any specific proposals on lenders' mortgage insurance (LMI), other than to note that APRA would continue to recognise some capital benefit for residential mortgages with LMI. Under the standardised approach, this was likely to be through the application of higher risk weights for loans with a LVR greater than 80 per cent that do not have LMI, while under the IRB approach, it could be recognised through the LGD estimates.

Comments received

Respondents supported the retention of a capital benefit for residential mortgages with LMI, with this benefit to be reflected through adjustments to the risk weights under the standardised approach and through supervisory inputs to the LGD calculation under the IRB approach. Respondents recommended that the capital benefit be equivalent under the standardised and IRB approach, and suggested that risk weights be reduced in the range of 30 to 50 per cent.

Some respondents also suggested that APRA consider expanding the choice of credit enhancement options available to ADIs, given the higher costs resulting from the current dependence on a small number of LMI providers in the Australian market.

APRA's response

Given the limited number of LMI providers, APRA is proposing to standardise the recognition of LMI within LGD models under the IRB approach. Where APRA has approved an ADI to use its own LGD estimates, APRA proposes to recognise up to a 20 per cent reduction to the LGD estimate (subject to the 10 per cent floor for IRB ADIs with approved LGD models) than would otherwise apply, where there is eligible LMI cover.

Under the standardised approach, APRA is proposing to apply a similar recognition for residential mortgage exposures covered by eligible LMI. Consistent with the current

approach under APS 112, APRA proposes to only recognise a capital benefit for residential mortgage exposures with an LVR greater than 80 per cent.

In relation to the suggestion that APRA expand the choice of credit enhancement options available to ADIs, APRA does not intend to recognise other insurance-like products; however, consistent with the current approach in APS 112, APRA will continue to recognise a range of credit risk mitigation techniques that ADIs may use to reduce their credit risk and regulatory capital requirements.

2.6 Difference in standardised and IRB mortgage capital requirements

The February 2018 discussion paper highlighted various options that APRA was considering in order to give effect to the unquestionably strong targeted increases in capital requirements of approximately 150 basis points for IRB ADIs and 50 basis points for standardised ADIs. Given the stated aim of targeting ADIs' structural concentration in residential mortgages as part of the capital increases, a necessary corollary is ensuring that the difference between the average risk weight under the IRB and standardised approaches is not of a magnitude that would create unwarranted competitive distortions.

Taking into account these considerations, APRA indicated that under the IRB approach it was likely to:

- apply a fixed multiplier to total credit RWAs;
- apply specific RWA multipliers to the residential mortgage and commercial property portfolios; and
- adopt the Basel III capital floor of 72.5 per cent on the amount of total RWA.

Comments received

On the application of multipliers, respondents expressed mixed views with some preferring capital adjustments to be done at the overall level and others preferring adjustments at the asset class level. In relation to the proposed application of multipliers to the residential mortgage portfolio, a number of respondents noted that in calibrating standardised and IRB requirements for residential mortgages, APRA's analysis should be broader than the difference in average risk weights between the two approaches, as this was not reflective of the additional capital held by IRB ADIs for expected loss and IRRBB.

Other respondents advocated for the capital floor being applied at the asset class level for residential mortgages, with some respondents also asserting that the level of the floor should be set to 100 per cent for this portfolio.

APRA's response

APRA continues to consider it appropriate for the prudential framework to provide for IRB risk weights to differ from those applied under the standardised approach. This outcome recognises that:

- the standardised approach is intended to be a simple and conservative approach that can produce appropriate outcomes for a wide range of ADIs. Standardised ADIs generally vary more greatly in terms of underlying risk, particularly in relation to their geographic or business concentration. To reduce complexity, the standardised approach does not require recognition of risk factors to the same extent as in IRB, so is set at a conservative level;
- IRB ADIs are subject to additional capital requirements relative to standardised ADIs. In particular, IRB ADIs have to hold capital against IRRBB and for expected loss, unlike standardised ADIs. This means a simple comparison of average risk weights is not fully representative of the actual capital being held against the portfolio;
- the difference between IRB and standardised capital requirements will vary over the credit cycle, as the IRB approach is more procyclical, so the difference will be larger in benign periods and smaller in stressed periods; and
- the IRB approach requires significant investments to establish and maintain the necessary systems and resources to operate the approach.

Risk weight differential in mortgage lending

For some time, there has been considerable interest in the impact, from a competition perspective, of the differential between standardised and IRB risk weights for mortgage lending.

Commentary on this issue has often focussed on the differential in average risk weights between ADIs using the two approaches. Superficially, this suggests a material differential exists. However, by only examining risk weights for on-balance sheet exposures, the impact of other important differences is ignored.

Beyond prescribed risk weights, differences in capital requirements for mortgage lending are driven by:

- differences in the credit quality of the underlying portfolio;
- differences in the 'unquestionably strong' capital benchmarks applied to standardised and IRB ADIs;
- differences in the treatment of credit conversion factors (CCFs) for standardised and IRB ADIs;
- the application of capital requirements for IRRBB to IRB, but not standardised, ADIs; and
- the requirement for an expected loss adjustment for IRB, but not standardised, ADIs.

Ignoring any differences in portfolio quality, each of the above factors serves to narrow any impact from standardised risk weights being higher than IRB risk weights. Under the current regulatory framework (i.e. before applying the proposals in this paper), APRA estimates that the impact of the overall difference in capital requirements on mortgage pricing is likely to be minimal – in the order of 5 basis points.

The analysis does not consider the operational costs arising from investing in developing and maintaining risk management systems to support IRB status, as well as data requirements.

Furthermore, the application of an additional capital buffer to those banks designated a domestically systemically important further narrows, if not completely eliminates, the overall difference for those banks.

APRA does not expect the changes proposed in this paper to materially change the above conclusions. When looked at holistically, the existing differential between the standardised and IRB approaches is small. While the precise calibration of the risk weights remains subject to further analysis, it is APRA's intention that any differential in overall capital requirements, and hence any impact on pricing by standardised and IRB ADIs, will remain negligible.

APRA does not agree with the suggestion that the capital floor should apply at the asset class level or that it should be set to 100 per cent for residential mortgages. The capital floor is intended to operate as a back-stop measure that limits the extent to which the application of the IRB approach can lead to lower overall capital requirements relative to the standardised approaches; it is not designed or intended to be the binding constraint for allocating capital at the level of a specific portfolio.

The final calibration of these proposals, including the potential application of an additional RWA multiplier, will be subject to additional consultation and informed by the additional quantitative impact studies to be undertaken.

2.7 Other housing issues

An additional issue raised in submissions concerned the treatment of loans to public housing companies and not-for-profit associations. Under the standardised approach, Basel III allows for these loans to be risk-weighted as an exception to the 'materially dependent' category, where an exposure secured by residential real estate to public housing companies and not-for-profit associations is regulated under a national law that exists to serve social purposes and to offer tenants long-term housing. Similarly, under the IRB approach, associations or cooperatives of individuals that satisfy certain criteria may be treated as retail residential mortgage exposures instead of income-producing real estate. Respondents proposed that a lower risk weight be applied to these exposures in order to provide certainty to social housing sector customers.

APRA's response

As highlighted above, APRA is not adopting the Basel III concept of 'materially dependent' for residential mortgage exposures under the standardised approach, so these exposures will be risk-weighted as 'other residential mortgages' where they are secured by residential property. Under the IRB approach, APRA does not consider that retail treatment is justified based on risk considerations.

Chapter 3 - Credit risk: other exposures under the standardised approach

This chapter sets out APRA's response to the other proposals on the standardised approach to credit risk that were consulted on in the February 2018 discussion paper.

3.1 Retail exposures

The February 2018 discussion paper proposed increasing the risk weight for most retail exposures from 100 per cent to 125 per cent, with the exception of credit cards which would continue to be risk-weighted at 100 per cent. Consistent with its implementation of Basel II, APRA did not propose to adopt the Basel III 'regulatory retail' risk weight of 75 per cent on the basis that it is inadequate for retail exposures, given that APRA stress tests have consistently shown that the retail portfolio experiences the highest potential loss rates in downturn scenarios relative to current levels of capital. APRA also did not propose to adopt the Basel III transactors category, as lowering the risk weight to 45 per cent could lead to a material rise in RWA during a downturn as borrowers move out of this category into one with a significantly higher risk weight.

Comments received

Respondents recommended that APRA adopt the Basel III regulatory retail category and risk weight of 75 per cent, and retain the current treatment of other retail risk-weighted at 100 per cent. Respondents considered that a risk weight of 100 per cent was sufficient to cover potential losses on this portfolio, and that the proposed increase does not reflect the performance and risk characteristics of these portfolios. Some respondents also proposed that recognition should be given for retail exposures that are secured by collateral such as car loans.

Several respondents also supported the adoption of the Basel III transactors category, and suggested narrowing the risk weight differential between transactors and other retail exposures as a means of addressing concerns about a material increase in RWA in a downturn.

APRA's response

APRA is proposing to retain a risk weight of 125 per cent for most retail exposures based on the potential loss rates of this portfolio, but recognises that a lower risk weight may be appropriate for:

- personal loans secured by vehicles – a risk weight of 100 per cent is proposed, acknowledging that the presence of some collateral mitigates losses in the event of default; and
- credit cards – while APRA still considers that adopting the Basel III transactors category is not appropriate due to the potential for procyclicality and misalignment with the risk

weights for residential mortgages, a lower risk weight of 75 per cent is now proposed given that capital requirements for these exposures will increase due to the application of higher credit conversion factors (refer to section 3.4.2).

3.2 SME exposures

APRA proposed that SME exposures secured by residential property would be included in the same category of exposures as residential mortgages for investment purposes and interest-only loans, and SME exposures secured by commercial property would be eligible for the commercial property risk weights. For SME exposures not secured by property, APRA proposed to reduce the current risk weight from 100 per cent to 85 per cent. APRA highlighted that it did not intend to adopt the Basel III 75 per cent risk weight for retail SME exposures, on the basis that there is insufficient evidence that these exposures exhibit a lower default or loss experience through the credit cycle as compared to corporate SME exposures.

Comments received

Respondents generally supported lowering the applicable risk weight from 100 per cent to 85 per cent for SME exposures not secured by property. Some respondents also advocated adopting the Basel III 75 per cent risk weight for retail SME exposures, on the basis that excluding this category would not materially improve financial safety or financial system stability. One respondent suggested APRA introduce a broad schedule of risk weights to apply to unsecured SME lending that takes into account differing risk profiles and the type of lending.

APRA's response

APRA is not proposing to adopt the Basel III regulatory retail treatment for SME exposures, as there is insufficient evidence that these exposures have a lower risk of default or loss when compared to corporate SME exposures. However, acknowledging the different types of SME lending and the presence of collateral other than housing, APRA is now proposing to introduce more granular risk weights for SME lending.

Recognising that collateral may act to mitigate losses in the event of default, APRA is proposing to allow ADIs to risk-weight SME exposures as set out in Table 3 below. Eligible collateral for this purpose includes motor vehicles, commercial property¹⁰ and plant, equipment and machinery.

¹⁰ 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 lower risk weight under the commercial property risk-weight schedule, ADIs may apply the SME risk weights.

Table 3. Proposed risk weights for unrated SME exposures

Exposure	Proposed %
Exposure ≤60 per cent of market value of physical collateral	75
Exposure is >60 ≤100 per cent of market value of physical collateral	85
Other SME exposures	100

As indicated in APRA’s submission to the Productivity Commission’s draft report on *Competition in the Australian Financial System*, APRA considers that an average risk weight of 85 per cent for SME lending, represents a sufficient amount of regulatory capital to absorb losses from the portfolio as a whole.¹¹ Accordingly, while some exposures may benefit from lower risk weights than those originally proposed, other exposures may have higher risk weights. APRA will use the results of the second QIS to further inform this calibration.

3.3 Margin lending

The February 2018 discussion paper highlighted APRA’s intention to review the capital treatment for margin lending exposures. The current capital treatment, applicable to both standardised and IRB ADIs, is to apply a risk weight of 20 per cent to an exposure secured by listed instruments on recognised exchanges. Where those exposures are not secured by listed instruments, and are not deducted from capital, they are to be treated as a secured loan. Typically, instruments not eligible for the 20 per cent risk weight, such as unlisted managed funds, would be risk-weighted at 100 per cent under the standardised approach.

Comments received

Respondents supported retaining the 20 per cent risk weight for margin lending exposures as a simple and adequate measure commensurate with the risk profile of the portfolio. A number of respondents also requested that APRA review the margin lending collateral eligible for the 20 per cent risk weight. These respondents requested that APRA consider including certain classes of unlisted managed funds as eligible collateral where those funds meet certain liquidity and redemption characteristics. In doing so, respondents noted that this would be aligned with the recognition, under Basel III, of certain forms of unlisted managed funds as eligible financial collateral for collateralised transactions such as margin lending.

APRA’s response

APRA proposes to retain the 20 per cent risk weight for margin lending exposures for both standardised and IRB ADIs. APRA acknowledges the argument made in submissions that unlisted managed funds with a high level of liquidity and redemption characteristics should

¹¹ APRA, ‘Productivity Commission draft report: Competition in the Australian Financial System’ (Submission, March 2018) <<https://www.apra.gov.au/submissions>>.

be eligible for the 20 per cent risk weight. Recognising the lower risk profile of margin lending and the existing approaches by ADIs to setting conservative lending limits for their margin lending products, APRA is proposing a number of changes to simplify the capital treatment of margin lending exposures including:

- aligning with Basel III by extending the list of eligible collateral for margin lending that may be risk-weighted at 20 per cent to include eligible financial collateral, as detailed in Attachment G to APS 112;
- amending eligible financial collateral under Attachment G to APS 112 to include unlisted managed funds where those funds exhibit positive liquidity and redemption characteristics, such as daily unit pricing and redemption requests that are met within a period no longer than 3 business days; and
- amending *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) to clarify that ADIs do not need to deduct indirect equity holdings held as collateral against a customer's margin lending portfolio.

3.4 Credit conversion factors

3.4.1 Definition of commitment

APRA proposed adopting the Basel III definition of commitment, such that a CCF must be applied to any credit exposure that has been offered by an ADI and accepted by the borrower, including any unconditionally cancellable arrangement.

Comments received

Most respondents supported the adoption of the Basel III definition of commitment, and also recommended that APRA adopt the Basel III national discretion to exempt certain arrangements from the definition of commitment where they comply with specific conditions.

APRA's response

APRA held discussions with a number of ADIs and the Australian Banking Association in order to develop a better understanding of current industry practices in relation to commitments. Following these discussions, APRA is proposing to adopt the Basel III definition of commitment and exercise national discretion to exempt certain arrangements from this definition, subject to some adjustments to the Basel III conditions to ensure that the criteria are more objectively measurable.

To be eligible for exemption from the definition of commitment, an arrangement would need to satisfy all of the following criteria:

- the ADI receives no fees or commissions to establish or maintain the arrangements – a commitment arises the moment any fee (irrespective of the materiality) is received in relation to the arrangement;
- the client is required to apply to the ADI for the initial and each subsequent drawdown – this requires a formal application by the client, in writing, for each drawdown;

- the ADI has full authority over the execution of each drawdown – the decision to advance funds under each drawdown must be at the sole discretion of the ADI; and
- the ADI's decision on the execution of each drawdown is only made after assessing the creditworthiness of the client immediately prior to drawdown – this condition will be met where a party independent of the client relationship manager confirms the client's creditworthiness as part of the drawdown approval process.

The proposal to exercise national discretion will result in a large number of arrangements that would otherwise have been classified as 'unconditionally cancellable' being exempted from the definition of commitment. A CCF of 10-20 per cent for the types of products that are likely to remain in this category (e.g. overdrafts), is not supported by empirical evidence. APRA is therefore proposing to remove the unconditionally cancellable category of commitments; those products that do not meet the criteria to be exempted would be subject to the CCFs applicable to the other categories of commitments.

3.4.2 Calibration of CCFs

APRA proposed to adopt the Basel III CCFs, with the exception of:

- other commitments, where APRA proposed to adopt CCFs in the range of 50 to 100 per cent rather than 40 per cent, based on the type of counterparty; and
- unconditionally cancellable commitments, where APRA proposed to adopt a CCF of 20 per cent instead of 10 per cent.

APRA also proposed to more closely align CCFs between the IRB and standardised approaches, which would result in increased capital requirements for some products which currently have a zero per cent CCF under the standardised approach.

Comments received

Several respondents requested that APRA adopt the Basel III CCFs for other commitments as the proposed treatment is materially higher than Basel and would lead to increases in capital and impact the competitive position of Australian ADIs relative to international peers. A number of respondents also commented that the proposed 100 per cent CCF for residential mortgage exposures is overly conservative and does not reflect the actual usage of these credit lines.

A couple of respondents also highlighted that the proposed CCF of 20 per cent for unconditionally cancellable commitments is overly conservative, and would be particularly punitive for short-term trade finance that demonstrates lower risk characteristics.

APRA's response

APRA is proposing to retain the CCF estimates proposed in the February 2019 discussion paper, subject to some minor adjustments. For large corporate counterparties, defined as corporate entities with greater than \$750m in total consolidated annual revenues, APRA is proposing to lower the CCF from 75 per cent to 50 per cent. All other corporate counterparties, excluding SMEs, will be subject to the 75 per cent CCF.

As indicated in section 3.4.1 above, with the exercise of national discretion to exclude certain arrangements from the definition of commitment, APRA is now proposing to remove the unconditionally cancellable commitments category. Short-term trade finance items that meet the conditions outlined above will be excluded from the definition of commitment; for those remaining items that are not excluded, a 20 per cent CCF remains appropriate.

Chapter 4 - Other amendments to the standardised approach

In addition to the proposals consulted on in February 2018, APRA is also proposing to make a number of other amendments to APS 112. These amendments reflect the adoption of the Basel III reforms, as well as other changes to better align definitions and the treatment of certain exposures under the standardised and IRB approaches.

4.1 Commercial property and land acquisition, development and construction

As indicated in the February 2018 discussion paper, APRA is proposing to adopt the Basel III risk weights for commercial property exposures and ADC exposures. The adoption of these risk weights introduces a more risk sensitive approach for these exposures, relative to the current approach which applies a flat risk weight of 100 per cent. Consistent with the treatment in Basel III, ADC exposures to residential property will need to meet certain criteria in relation to pre-sales and development costs in order to be eligible for the 100 per cent risk weight.

4.2 Sovereign exposures

While the proposed amendments to APS 112 would not alter the risk weights applied to sovereign exposures, they do include a definition of sovereign exposures that consistently defines the sovereign asset class across the standardised and IRB approaches. The proposed definition includes all exposures to Australian and overseas central and subnational governments, all exposures to the Reserve Bank of Australia and overseas central banks, as well as certain exposures to highly rated institutions (e.g. the Bank for International Settlements and the International Monetary Fund) and multilateral development banks.

4.3 Bank exposures

APRA's proposals for bank exposures include adopting the Basel III risk weights for rated bank exposures, but not the criteria and approach for unrated bank exposures. The Basel III reforms set out criteria for risk-weighting unrated exposures based on counterparty grades. APRA considers that it would be difficult to ensure that these criteria are interpreted and applied in a consistent manner; hence, for the purposes of simplicity and consistency, is proposing to retain a flat risk weight of 20 per cent for short-term exposures and 50 per cent for long-term exposures consistent with the existing APS 112 risk weights.

APRA is also proposing to adopt the Basel III treatment of covered bonds, which allows for these exposures to be risk-weighted lower than other bank exposures provided certain criteria are met. While APRA is proposing to adopt the Basel III risk weights for rated covered bond exposures, for simplicity, unrated covered bonds will be risk-weighted as bank exposures given these exposures are not common in the Australian market.

4.4 Corporate exposures

APRA is proposing to adopt the Basel III risk weights for corporates (excluding SME exposures), which includes a more granular risk weight schedule for rated corporate exposures, and a specific treatment for specialised lending exposures.

4.5 Equity and subordinated debt

In line with the revised Basel III treatment, the February 2018 discussion paper highlighted APRA's intention to review the current risk weights for equity and subordinated debt.

4.5.1 Equity exposures

APRA's longstanding view has been that ADIs' equity investments should be funded by the shareholders rather than depositors of an ADI, and has therefore required most equity investments to be deducted from the corresponding tier of capital. ADIs may currently risk-weight equity exposures to ADI and insurance subsidiaries at Level 1 and underwriting positions held for five working days or less, at 300 per cent if the exposure is listed on a recognised exchange or otherwise at 400 per cent.

While not proposing to widen the scope of equity exposures that may be risk-weighted rather than deducted, APRA is proposing to adopt the Basel III risk weight of 250 per cent for equity exposures that are listed on a recognised exchange. Rather than adopt the Basel III concept of speculative and non-speculative investments, the proposals would retain the current distinction between listed and unlisted equity exposures, as this allows for a more objective and consistent classification across ADIs.

More broadly, APRA will be reviewing its current approach to risk-weighting ADI's equity exposures to subsidiaries at Level 1, as part of its review of APS 111 later this year.

4.5.2 Subordinated debt

The February 2018 discussion paper signalled APRA's intention to review the current risk weight of 100 per cent for holdings of subordinated debt issued by commercial entities, as well as the definition of subordinated exposures. No change is proposed in relation to the treatment of subordinated debt issued by financial institutions, as this will in most instances form part of, or be equivalent to, regulatory capital and is therefore more appropriately deducted from the corresponding tier of capital.

APRA proposes to adopt the Basel III risk weight of 150 per cent for subordinated debt issued by commercial (non-financial) entities. For this purpose, a definition of subordination that captures both contractual and structural subordination has been included in the draft APS 112.

4.6 Other exposures

APRA is also proposing amendments to the treatment of certain other exposures, as set out below.

4.6.1 Exposures originated through third parties

APRA has observed an increasing number of smaller ADIs incurring credit risk exposures through third parties, such as online lending platforms. A number of these arrangements involve third-party operators undertaking the credit assessment and approval of the underlying borrowers according to their credit policies and processes, rather than the ADI's policies. As highlighted in the proposals for the revised *Prudential Standard APS 220 Credit Risk Management*,¹² while ADIs will be required to undertake due diligence for these exposures, APRA also considers that a higher risk weight is appropriate given the increased risks involved in this type of lending.

Exposures under these arrangements appear to relate predominantly to the provision of unsecured retail finance, but with the ADI unable to directly administer the workout or default processes. Given these characteristics, APRA considers that a risk weight higher than that applied to other retail exposures is appropriate and therefore proposes a risk weight of 150 per cent for these exposures.

4.6.2 Exposures to lease assets

The February 2018 paper noted that APRA has prudential concerns regarding ADIs holding significant exposures to physical assets where the capital held for such risks is not commensurate with the asset valuation and concentration risks. In particular, this risk may be acute for ADIs that maintain a significant physical asset portfolio as a lessor of assets under an operating lease.

Recognising the broad nature of this asset class, APRA proposes to retain the current 100 per cent risk weight subject to an ADI's aggregate leasing assets being below a threshold of 10 per cent of Tier 1 Capital. Exposures above the threshold would be required to be risk weighted at 250 per cent.

4.6.3 Risk weight multiplier for exposures with currency mismatch

APRA is proposing to incorporate the Basel III requirement to apply a multiplier of 1.5 to the applicable risk weight for any unhedged retail and residential property exposures to individuals, where the lending currency differs from the currency of the borrower's income.

4.7 Defaulted exposures

APRA intends to adopt a consistent definition of defaulted exposure across the standardised and IRB approaches. The definition of a defaulted exposure has now been included in APS 112, and reflects the current definition of default under APS 113.

Additionally, for defaulted residential mortgages, APRA is proposing to simplify the current treatment and adopt the following risk weights:

¹² APRA, *APS 220 Credit Risk Management* (Discussion Paper, March 2019) <<https://www.apra.gov.au/adi-consultation-packages>>.

- 100 per cent for residential mortgages without LMI; and
- 90 per cent for residential mortgages covered by eligible LMI, consistent with the application of a discount to performing residential mortgages and retaining relativities between performing and defaulted exposures.

For all other defaulted assets, APRA proposes to retain the current treatment which, consistent with the Basel III reforms, requires ADIs to risk-weight defaulted exposures at 100 per cent where a specific provision has been raised that is at least 20 per cent of the outstanding exposure amount.

4.8 Credit risk mitigation

APRA is proposing to make a number of changes to the credit risk mitigation (CRM) requirements, primarily to incorporate the Basel III reforms, but also to improve the structure and clarity of the requirements and ensure consistency with other prudential standards.

In relation to collateralised transactions, the proposed amendments include:

- the removal of own-estimate haircuts under the comprehensive approach to eligible financial collateral;
- the recalibration of certain supervisory haircuts under the comprehensive approach;
- increased granularity of maturity buckets for debt instruments;
- the removal of the zero per cent risk weight for collateralised over-the-counter derivative transactions;
- the removal of the VaR models approach for securities financing transactions (SFTs);
- the introduction of minimum haircut floors for SFTs; and
- expanding the list of eligible financial collateral to also include certain securitisation exposures and units in unlisted trusts where these satisfy certain liquidity and redemption criteria (refer to section 3.3 above), and removing the current concession that allows instruments included in the trading book that would not otherwise qualify as eligible collateral, to be recognised as eligible collateral for SFTs.

In relation to credit derivatives, credit protection purchased using first-to-default or second-to-default derivatives will no longer be recognised as eligible CRM, consistent with Basel III. A number of changes have also been made to the structure of existing requirements (e.g. grouping requirements for credit protection bought and credit protection sold separately) to allow for these to be more easily read.

In relation to netting, the proposed amendments are intended to clarify the requirements that must be satisfied in order to recognise on-balance sheet netting and netting across market-related products. APRA has also removed the requirement that an ADI's netting policy must be approved by the Board of Directors, consistent with APRA's commitment to place greater

reliance on *Prudential Standard CPS 220 Risk Management* to describe the obligations of the Board.¹³

4.9 Use of external credit ratings

In line with the Basel III reforms, APRA is proposing to require that ADIs conduct appropriate due diligence where they use the credit ratings of external credit assessment institutions (ECAIs) to assign risk weights to exposures. Where the due diligence undertaken indicates a lower credit quality than that determined by the external rating, an ADI will be required to assign a risk weight at least one bucket higher than would otherwise apply.

¹³ APRA, 'The review of board requirements' (Letter, 28 August 2015) <<https://www.apra.gov.au/letters-notes-advice-adis>>.

Chapter 5 - Operational risk

This chapter outlines APRA's response to submissions regarding the proposed revisions to the capital treatment of operational risk.

5.1 Capital calculation

Consistent with the Basel III reforms, APRA proposed replacing the Advanced Measurement Approach (AMA) and the standardised approach with the single Standardised Measurement Approach (SMA). In adopting the SMA, APRA also highlighted its intention to exercise national discretion to not implement the loss component, and instead set the operational risk requirement equal to the business indicator component (BIC). APRA proposed applying the SMA to all ADIs, except those included within the simplified framework which would instead be subject to a flat-rate capital add-on for operational risk (refer to Chapter 6).

Comments received

Respondents were supportive of APRA's proposed implementation of the SMA without the loss component, noting that this would reduce the potential volatility and complexity of the operational risk capital framework. Respondents requested that APRA provide additional clarity and guidance on advanced risk management expectations, the treatment of legal and insurance costs and the treatment of boundary events. One respondent also suggested that APRA consider deductions where ADIs have insurance, provided they are able to demonstrate an adequate level of cover.

APRA's response

The accompanying draft APS 115 has been revised to reflect the requirements of the SMA, excluding the loss component. Regarding the request that APRA provide additional clarity and guidance on a number of items, APRA intends to consult on a new cross-industry prudential standard covering operational risk management, including advanced risk management expectations, later this year. Consistent with the Basel III reforms, APRA does not intend to recognise any deductions for ADIs with insurance coverage as part of the operational risk capital framework.

5.2 Early implementation

APRA proposed to implement the changes to the operational risk framework from 1 January 2021, at the same time as the other revisions to the capital framework.

Comments received

While respondents generally expressed a preference for APRA to align the implementation of all the capital framework changes with the Basel Committee's internationally agreed date of 1 January 2022, some support was expressed for adopting an earlier implementation date for the revised APS 115.

APRA's response

APRA is proposing to retain an earlier implementation date of 1 January 2021 for the revised APS 115 for ADIs currently using an AMA; for other ADIs (currently subject to the requirements of *Prudential Standard APS 114 Capital Adequacy Standardised Approach to Operational Risk*) the implementation date of APS 115 would be aligned with the other changes to the capital framework, i.e. 1 January 2022.

APRA considers that an earlier implementation date for ADIs using an AMA will be advantageous, as the more onerous model maintenance requirements in the current APS 115 will be replaced with the SMA requirements. Given the removal of AMA, the model-based estimates for operational risk are likely to become increasingly unreliable. Replacing the modelled outcomes, and enforcing this through the revised APS 115, is expected to provide ADIs with greater clarity in calculating their operational risk capital requirements.

Chapter 6 - Simplified framework

This chapter sets out APRA's response to submissions on the introduction of a simplified framework that could be applied to smaller, less complex ADIs.

6.1 Scope of a simplified framework

For smaller, less complex ADIs, APRA proposed adopting operationally simpler prudential requirements for operational risk, counterparty credit risk, the leverage ratio and public disclosures.

Comments received

Respondents supported the adoption of simpler prudential requirements in the areas identified by APRA, with no respondents suggesting any additional areas of focus at this time.

APRA's response

APRA intends to adopt the proposed measures as detailed in the February 2018 Discussion Paper. The proposed implementation timeline is outlined in Table 4 below.

Table 4. Proposals within the simplified framework

Risk area	Simpler requirement	Implementation
Operational risk	Flat-rate capital add-on	APRA is proposing a flat-rate capital add-on of 10 per cent of RWA, subject to further calibration following the second QIS. The operational risk capital requirement is intended to commence on 1 January 2022.
Counterparty credit risk (CCR)	No CCR capital requirements; however, small ADIs will be subject to reporting requirements under <i>Reporting Standard ARS 180.0 Counterparty Credit Risk</i> .	Small ADIs would be exempt from the CCR capital requirement in <i>Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk</i> (APS 180) from 1 January 2022. Along with other consequential amendments, APRA will consult on a revised APS 180 in due course.
Leverage ratio	No leverage ratio requirement; however, small ADIs will be required to report a limited number of items under <i>Reporting Standard ARS 110.1 Leverage Ratio</i> (ARS 110.1) to enable APRA to	The revised ARS 110.1 is intended to commence on 1 January 2022. APRA expects to release the final reporting standard in 2020.

Risk area	Simpler requirement	Implementation
	disclose leverage ratios on behalf of these ADIs.	
Disclosure	Centralised publication by APRA of key prudential measures on behalf of small ADIs and greater reliance on ADIs' own financial reporting for disclosures relating to remuneration and regulatory capital instruments.	APRA intends to consult on these changes as part of its consultation on <i>Prudential Standard APS 330 Public Disclosure</i> (APS 330) in 2020.

6.2 Eligibility criteria

APRA proposed the use of an objective quantitative measure, as well as certain qualitative criteria, to define a small ADI, and sought feedback on an appropriate size threshold for this purpose. APRA also proposed that ADIs which met the eligibility criteria would automatically be subject to the simplified framework, although supervisors would have the discretion to require ADIs that would otherwise be eligible, to apply the more complex prudential requirements.

Comments received

Respondents supported APRA's proposal to use total assets and other qualitative requirements as the criteria to define eligibility for inclusion within the simplified framework, but also suggested that ADIs should have the choice to opt out. A number of respondents suggested that the simplified framework should apply to the entire mutual ADI sector, asserting that mutual ADIs are smaller and less complex when compared to other Australian ADIs. One respondent suggested a size threshold of \$20 billion in total assets, while another respondent suggested the use of the Minimum Liquidity Holdings designation.

APRA's response

As indicated in APRA's response to submissions on the leverage ratio requirement,¹⁴ APRA considers that \$15 billion in total assets is an appropriate size threshold for the simplified framework. A quantitative threshold set at this level will cover all mutual ADIs, and is expected to reduce regulatory burden and complexity, without compromising financial safety and soundness.

The quantitative threshold of \$15 billion in total assets would be supplemented by qualitative criteria requiring ADIs within the framework to have simple and domestic activities. This would exclude any ADIs with a trading book, material non-centrally cleared derivatives exposures, offshore funding and purchased payment facility providers. Further, foreign

¹⁴ APRA, 'APRA responds to submission on leverage ratio, and extends timeline for broader capital framework reforms' (Media Release, 27 November 2018) <<https://www.apra.gov.au/media-centre/media-releases/apra-responds-submissions-adi-leverage-ratio-and-extends-timeline>>.

subsidiary banks and foreign ADIs would not be eligible for the simplified framework. APRA will periodically review the eligibility criteria.

ADIs which satisfy the eligibility criteria would automatically be subject to the simplified framework and accordingly there will be no automatic opt-out provision. APRA supervisors will also have the discretion to require a small ADI to use the more complex framework.

APRA will include the definition of a small ADI in *Prudential Standard APS 001 Definitions* when it is updated as part of the consequential amendments flowing from the revisions to the capital framework.

Chapter 7 - Consultation and next steps

7.1 Request for submissions and cost-benefit analysis information

APRA invites written submissions on the proposals set out in this response paper and the accompanying draft standards. Written submissions should be sent to ADIpolicy@apra.gov.au by 6 September 2019 and addressed to:

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

Important disclosure notice – publication of submissions

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

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

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

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

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

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

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

APRA requests that respondents use this methodology to estimate costs to ensure the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their costs assessment to APRA, respondents should include any assumptions

made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that institutions would undertake due to foreign regulatory requirements or in their ordinary course of business.

7.2 Next steps

APRA intends to issue a response package on other amendments to the IRB approach and the proposals to improve the transparency, comparability and flexibility of the capital framework in the second half of 2019, and will likely conduct another QIS at that time. APRA also expects to release its response to the proposed changes to IRRBB requirements in the second half of 2019.

APRA intends to commence consultation on a revised APS 330, revised reporting standards and revised prudential practices guides in 2020. Consultation on consequential amendments to other prudential standards is expected to occur in 2021.

As indicated in the response paper on the leverage ratio, APRA is proposing to implement the revised capital requirements from 1 January 2022, consistent with the internationally agreed timeframe, with the exception of the operational risk capital requirements for ADIs currently using an AMA for operational risk, which may be implemented from 1 January 2021.

Table 5. Timeline

	1st half 2019	2nd half 2019	1st half 2020	2nd half 2020	Effective date
Standardised approach to credit risk (APS 112)	Consult		Consult	Finalise	2022
Internal ratings-based approach to credit risk (APS 113)		Consult		Finalise	2022
Operational risk (APS 115)	Consult	Finalise			2021 (AMA) 2022 (other ADIs)
Interest rate risk in the banking book (APS 117)		Consult		Finalise	2022
Capital floor		Consult		Finalise	2022
Public disclosures (APS 330)			Consult	Finalise	2022
Improving transparency, comparability and flexibility		Consult		Finalise	

Attachment A: Standardised approach to credit risk proposals

The tables in this Attachment provide a summary of key risk weights (RW) and CCFs under the current APS 112, the Basel III framework standardised approach to credit risk and those proposed by APRA.

Residential property exposures

Table 1. Standard mortgages: owner-occupied principal-and-interest

LVR %	APS 112 RW %		Basel III RW ¹⁵ %	Proposed RW %	
	LMI	No LMI		LMI	No LMI
0-50	35	35	20	20	20
50.01-60	35	35	25	25	25
60.01-80	35	35	30	35	35
80.01-90	35	50	40	45	55
90.01-100	50	75	50	60	70
>100.01	75	100	70	80	85

¹⁵ Under the Basel III framework, these risk weights are for exposures where repayment is not materially dependent on cash flows from the secured property.

Table 2. Standard mortgages: investment, interest-only, SME secured by residential property

LVR %	APS 112 RW %		Basel III RW ¹⁶ %	Proposed RW %	
	LMI	No LMI		LMI	No LMI
0-50	35	35	30	25	25
50.01-60	35	35	35	30	30
60.01-80	35	35	45	45	45
80.01-90	35	50	60	60	70
90.01-100	50	75	75	75	85
>100.01	75	100	105	90	95

Table 3. Non-standard residential mortgages

LVR %	APS 112 RW %		Basel III RW %		Proposed RW %	
	Reverse mortgages	Other non-std	Not materially dependent	Materially dependent	Reverse mortgages	Other non-std
0-50	50	35	RW _{cp} ¹⁷	150	50	100
50.01-60		50				
60.01-80	75					
80.01-90	100					
90.01-100	Impaired	100			Defaulted	

¹⁶ Under the Basel III framework, these risk weights are for exposures where repayment is materially dependent on cash flows from the secured property.

¹⁷ Risk weight of the counterparty. For exposures to individuals, the risk weight under the Basel III framework reforms is 75 per cent.

Commercial property exposures

Table 4. Repayment is not materially dependent on cash flows generated by the property

Category	APS 112 RW %	Basel III RW %	Proposed RW %
LVR ≤ 60%	100	Min (60, RWcp)	Min (60, RWcp)
LVR > 60%	100	RWcp	RWcp
Non-standard	100	RWcp	RWcp

Table 5. Repayment is materially dependent on cash flows generated by the property

Category	APS 112 RW %	Basel III RW %	Proposed RW %
LVR ≤ 60%	100	70	70
60% < LVR ≤ 80%	100	90	90
LVR > 80%	100	110	110
Non-standard	N/A	150	150

Table 6. Land acquisition, development and construction

Category	APS 112 RW %	Basel III RW %	Proposed RW %
Residential property - significant pre-sales or substantial equity at risk	100	100	100
Other	100	150	150

Sovereign exposures and domestic public sector entities

Table 7. Sovereign exposures

Category	APS 112 RW %	Basel III RW %	Proposed RW %
AAA to AA-	0	0	0
A+ to A-	20	20	20
BBB+ to BBB-	50	50	50
BB+ to B-	100	100	100
Below B-	150	150	150
Unrated	100	100	100

Table 8. Exposures to domestic public sector entities

Category	APS 112 RW %	Basel III RW %	Proposed RW %
AAA to AA-	20	20	20
A+ to A-	50	50	50
BBB+ to BBB-	100	50	50
BB+ to B-	100	100	100
Below B-	150	150	150
Unrated	100	50	50

Bank exposures

Table 9. Exposures to banks with an original maturity of three months or less

Category	APS 112 RW %	Basel III RW %	Proposed RW %
AAA to AA-	20	20	20
A+ to A-	20	20	20
BBB+ to BBB-	20	20	20
BB+ to B-	50	50	50
Below B-	150	150	150
Unrated	20	Grade A: 20 Grade B: 50 Grade C: 150	20

Table 10. Exposures to banks with an original maturity of more than three months

Category	APS 112 RW %	Basel III RW %	Proposed RW %
AAA to AA-	20	20	20
A+ to A-	50	30	30
BBB+ to BBB-	50	50	50
BB+ to B-	100	100	100
Below B-	150	150	150
Unrated	50	Grade A: 30/40 Grade B: 75 Grade C: 150	50

Table 11. Rated covered bond exposures

Credit rating grade	APS 112 RW %	Basel III RW %	Proposed RW %
AAA to AA-	N/A	10	10
A+ to A-		20	20
BBB+ to BBB-		20	20
BB+ to B-		50	50
Below B-		100	100

Table 12. Unrated covered bond exposures

Issuing bank RW %	APS 112 RW %	Basel III RW %	Proposed RW %
20	N/A	10	RW of issuing bank (long-term)
30		15	
40		20	
50		25	
75		35	
100		50	
150		100	

Corporate exposures

Table 13. General corporate exposures

Credit rating grade	APS 112 RW %	Basel III RW %	Proposed RW %
AAA to AA-	20	20	20
A+ to A-	50	50	50
BBB+ to BBB-	100	75	75
BB+ to BB-	100	100	100
Below BB-	150	150	150
Unrated - other	100	100	100

Table 14. SME exposures

Credit rating grade	APS 112 RW %	Basel III RW %	Proposed RW %
Unrated - retail SME	100	75	75/85/100
Unrated - corporate SME	100	85	75/85/100

Table 15. Specialised lending exposures

Category	APS 112 RW %	Basel III RW %	Proposed RW %
Object and commodities finance	100	100	100
Project finance (pre-operational)	100	130	130
Project finance (operational phase - high quality)	100	80	80
Project finance (operational phase - other)	100	100	100

Retail exposures

Table 16. Retail exposures

Category	APS 112 RW %	Basel III RW %	Proposed RW %
Regulatory retail-transactors	100	45	Credit cards: 75 Auto loans: 100 Other retail: 125
Regulatory retail - other	100	75	Credit cards: 75 Auto loans: 100 Other retail: 125
Other retail	100	100	Credit cards: 75 Auto loans: 100 Other retail: 125

Equity and subordinated debt

Table 17. Equity and subordinated debt exposures

Category	APS 112 RW %	Basel III RW %	Proposed RW %
Subordinated debt (to commercial non-financial entities)	100	150	150
Capital instruments other than equities	Deducted	150	Deducted
Equity exposures that are not deducted and are:			
—listed on a recognised exchange	300	250	250
—not listed on a recognised exchange - non-speculative	400	250	400
—not listed on a recognised exchange - speculative	400	400	400
Margin lending against listed instruments on recognised exchanges that is not deducted from capital	20	N/A	20

Credit conversion factors

Table 18. Off-balance sheet transactions

Category	APS 112 CCF %	Basel III CCF %	Proposed CCF %
Direct credit substitutes	100	100	100
Sale & repurchase agreements and asset sales with recourse	100	100	100
Lending or posting of securities as collateral	100	100	100
Forward asset purchases, forward deposits and partly paid shares & securities	100	100	100
Other off-balance sheet items that are credit substitutes	100	100	100
Unsettled securities, commodities & FX transactions accounted for at settlement date	100	100	100
Other commitments with certain drawdown	100	100	100
Note issuance and underwriting facilities	50	50	50
Performance-related contingencies	50	50	50
Other commitments —unconditionally cancellable at any time without notice	0	10	N/A
—short-term self-liquidating trade letters of credit	20	20	20
—retail credit cards	0	40	50
—otherwise to a sovereign, domestic public sector entity, bank or large corporate counterparty ¹⁸	20 (<1 year) 50 (>1 year)	40	50
—otherwise to a corporate counterparty, excluding SMEs	20 (<1 year) 50 (>1 year)	40	75

¹⁸ A large corporate counterparty for this purpose, is a corporate entity with greater than \$750m in total consolidated annual revenues.

Category	APS 112 CCF %	Basel III CCF %	Proposed CCF %
—otherwise to other counterparties	20 (<1 year) 50 (>1 year)	40	100
Irrevocable standby commitments under industry support arrangements	0	0	0



APRA