Prudential Standard APS 112

Capital Adequacy: Standardised Approach to Credit Risk

Objectives and key requirements of this Prudential Standard

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

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

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

Table of Contents

Authority 3
Application and commencement 3
Interpretation 3
Adjustments and exclusions 3
Previous exercise of discretion 4
Scope 4
Definitions 4
Key principles 7
Risk-weighting approach 7
Credit risk mitigation 8
Attachment A – Risk weights for property exposures 9
Attachment B – Risk weights for non-property exposures 17
Attachment C – Off-balance sheet commitments 28
Attachment D – Unsettled and failed transactions 30
Attachment E – Defaulted exposures 32
Attachment F – External credit ratings 33
Attachment G – Collateralised transactions 36
Attachment H – Netting 46
Attachment I – Guarantees 49
Attachment J – Credit derivatives 53

Authority

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

Application and commencement

2. This Prudential Standard applies to all authorised deposit-taking institutions (**ADI**s) with the exception of:

   (a) **foreign ADIs**; and

   (b) **purchased payment facility providers**.

3. A reference to an ADI in this Prudential Standard, unless otherwise indicated, is a reference to:

   (a) an ADI on a **Level 1** basis; and

   (b) a **group** of which an ADI is a member on a **Level 2** basis.

4. If an ADI to which this Prudential Standard applies is:

   (a) the holding company for a group, the ADI must ensure that the requirements in this Prudential Standard are met on a Level 2 basis, where applicable; or

   (b) a **subsidiary** of an authorised **non-operating holding company** (**authorised NOHC**), the authorised NOHC must ensure that the requirements in this Prudential Standard are met on a Level 2 basis, where applicable.

5. This Prudential Standard commences on 1 J~~uly~~anuary 202~~5~~7.

Interpretation

6. Terms that are defined in *Prudential Standard CPS 001 Defined terms* appear in bold the first time they are used in this Prudential Standard.

7. Where this Prudential Standard provides for APRA to exercise a power or discretion, the power or discretion is to be exercised in writing.

8. In this Prudential Standard, unless the contrary intention appears, a reference to an Act, Regulations or Prudential Standard is a reference to the Act, Regulations or Prudential Standard as in force from time to time.

Adjustments and exclusions

9. APRA may adjust or exclude a specific prudential requirement in this Prudential Standard in relation to one or more specified ADIs or authorised NOHCs.[1]

[1] Refer to subsection 11AF(2) of the Banking Act.

Previous exercise of discretion

10. An exercise of APRA's discretion (such as an approval, waiver or direction) under a previous version of this Prudential Standard continues to have effect as though exercised pursuant to a corresponding power (if any) exercisable by APRA under this Prudential Standard.

Scope

11. The following items are excluded from the scope of this Prudential Standard:

    (a) assets or investments that are required to be deducted from **Common Equity Tier 1 Capital**, ~~**Tier 1 Capital,**~~ or **Total Capital** under *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111);

    (b) **securitisation** exposures that are subject to the requirements of *Prudential Standard APS 120 Securitisation* (APS 120), excluding funding-only or synthetic securitisations for which an ADI must include the underlying exposures in the pool in its calculation of the **Regulatory Capital** requirement for credit risk under this Prudential Standard;

    (c) liabilities of a covered bond special purpose vehicle to an issuing ADI as specified in *Prudential Standard APS 121 Covered Bonds*; and

    (d) items that are subject to capital requirements under *Prudential Standard APS 116 Capital Adequacy: Market Risk* that do not have counterparty credit risk exposure under *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180).

12. Subject to paragraph 13 of this Prudential Standard, an ADI must apply the requirements set out in this Prudential Standard to calculate risk-weighted assets (RWA) for any credit exposures of overseas banking subsidiaries that form part of the Level 2 group.

13. For the purpose of calculating the Level 2 Regulatory Capital requirement for the credit exposures of an overseas banking subsidiary that is prudentially regulated by a prescribed New Zealand authority, an ADI must calculate RWA using the prescribed New Zealand authority's equivalent prudential rules as in force from time to time.[2, 3]

Definitions

14. The following definitions are used in this Prudential Standard:

    (a) bank – means an ADI or overseas bank;

---

2 Prescribed New Zealand authority has the meaning given in subsection 5(1) of the Banking Act.

3 For APS 112 purposes, an ADI may exclude credit risk RWA that arise from securities held in the trading book when applying the prescribed New Zealand authority's equivalent prudential rules.

(b) commitment – has the meaning given in paragraphs 1 to 3 of Attachment C to this Prudential Standard;

(c) commodities finance – has the meaning given in paragraph 27(c) of Attachment B to this Prudential Standard;

(d) corporate exposure – has the meaning given in paragraph 18 of Attachment B to this Prudential Standard and includes general corporate exposures and specialised lending exposures;

(e) counterparty credit risk – means the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions, or portfolio of transactions, with the counterparty has a positive economic value at the time of default;

(f) credit conversion factor (CCF) – means the percentage value used to convert an off-balance sheet exposure into an on-balance sheet equivalent;

(g) credit protection – means the extent of credit risk transference from the party buying credit protection to the party selling credit protection under the terms of a guarantee or credit derivative contract;

(h) defaulted exposure – means a non-performing exposure as defined in *Prudential Standard APS 220 Credit Risk Management* (APS 220);

(i) domestic public sector entity (PSE) – has the meaning given in paragraph 6 of Attachment B to this Prudential Standard;

(j) eligible bilateral netting agreement – means a **netting** agreement that meets the requirements set out in paragraph 9 of Attachment H to this Prudential Standard;

(k) eligible credit risk mitigation (CRM) – means any of the credit risk mitigation techniques detailed in Attachments G to J of this Prudential Standard;

(l) eligible financial collateral – means collateral listed in paragraphs 14 or 22 of Attachment G to this Prudential Standard;

(m) equity exposure – has the meaning given in paragraphs 34 to 37 of Attachment B to this Prudential Standard;

(n) general corporate exposure – means a corporate exposure that is not a specialised lending exposure;

(o) lenders' mortgage insurance (LMI) – means mortgage insurance that meets the requirements set out in paragraph 15 of Attachment A to this Prudential Standard;

(p) loan-to-valuation ratio (LVR) – means a ratio calculated by dividing the amount of the loan by the value of the property or properties used to secure repayment;

(q) netting set – has the meaning given in APS 180;

(r) non-standard loan – means a property exposure that does not satisfy any of the requirements set out in paragraphs 3 to 7 of Attachment A to this Prudential Standard, or a loan that has the meaning given in paragraph 19 of Attachment A to this Prudential Standard;

(s) object finance – has the meaning given in paragraph 27(b) of Attachment B to this Prudential Standard;

(t) off-balance sheet exposure – means an exposure which is within the scope of Attachment C to this Prudential Standard or APS 180;

(u) over-the-counter (OTC) derivative transaction – means a customised, privately negotiated, risk-shifting agreement, the value of which is derived from the value of an underlying asset;

(v) overseas bank – means a financial institution incorporated outside of Australia, which is not an ADI and:

(i) has the power to accept deposits in the ordinary course of business;

(ii) is supervised by the bank supervisor in its home country; and

(iii) is subject to substantially the same prudential requirements as ADIs;

(w) project finance – has the meaning given in paragraph 27(a) of Attachment B to this Prudential Standard;

(x) property exposure – has the meaning given in Attachment A to this Prudential Standard;

(y) related-party exposure – means the exposure of an ADI to a related entity as defined in *Prudential Standard APS 222 Associations with Related Entities*. A related-party exposure would be classified according to the asset class definitions in Attachment B of this Prudential Standard. For example, if an ADI has an exposure to a related entity that is a corporate counterparty, the exposure is classified as a corporate exposure;

(z) risk-weighted assets (RWA) – means the credit exposures of an ADI multiplied by a percentage factor, as calculated in accordance with paragraphs 19 to 21 of this Prudential Standard;

(aa) securities financing transaction (SFT) – means a transaction such as a repurchase agreement, reverse repurchase agreement or a securities lending and borrowing transaction where the value of the transaction depends on the market valuation of securities and the transaction is typically subject to margin agreements;

(bb) small- and medium-sized enterprise (SME) – has the meaning given in paragraph 22 of Attachment B to this Prudential Standard;

(cc) sovereign – has the meaning given in paragraph 3 of Attachment B to this Prudential Standard; and

(dd) specialised lending – has the meaning given in paragraph 26 of Attachment B to this Prudential Standard.

Key principles

15. An ADI must hold Regulatory Capital commensurate with its exposure to credit risk, based on the application of specified risk weights and CCFs (where applicable) as set out in this Prudential Standard. Where appropriate, an ADI must use the ratings of **external credit assessment institutions** (**ECAIs**) to determine the **credit rating grade** and risk weight of an exposure, as set out in Attachments B and F to this Prudential Standard.

16. An ADI must establish and implement effective internal policies, processes, systems and controls to ensure that appropriate risk weights are assigned to its credit exposures.

17. An ADI may reduce its credit risk Regulatory Capital requirement through the use of LMI or eligible CRM techniques.

18. If an ADI seeks to use LMI or eligible CRM techniques to reduce its Regulatory Capital requirements, it must have established and implemented effective policies, procedures and systems that meet the requirements set out in this Prudential Standard. An ADI's policies and procedures must also address any residual risks such as legal, operational, liquidity and market risks that result from its use of CRM.

Risk-weighting approach

Risk-weighted on-balance sheet assets

19. An ADI must calculate the RWA of an on-balance sheet exposure by multiplying the current book value[4] of the exposure (including accrued interest or revaluations, and net of any provisions for defaulted exposures, partial write-off or associated depreciation) by the relevant risk weight. Where an ADI has liquid assets[5] accounted for at amortised cost, the ADI may adjust its exposures for deductions from Common Equity Tier 1 Capital to reflect unrealised fair value losses at a portfolio level as allowed under paragraph 41 of Attachment D to APS 111.

[4] When determining the current book value of the exposure, an ADI is permitted to net the trail commission asset with its corresponding liability, provided the following conditions are met: (i) the trail commission asset must only reflect expected future trail commissions payable; (ii) the trail commission asset must be extinguished upon loan default, refinancing (or under any other conditions or events specified in the contract); and (iii) the trail commission asset cannot be less than the corresponding liability, and no net positive impact on Common Equity Tier 1 capital occurs.

[5] Refer to *Prudential Standard APS 210 Liquidity*.

Risk-weighted off-balance sheet exposures

20. The RWA of a non-SFT off-balance sheet exposure must be calculated by applying the following two-step process:

    (a) first, the exposure amount or exposure at default (EAD), representing the on-balance sheet equivalent amount, must be determined according to:

        (i) Attachment C to this Prudential Standard for any commitments; and

        (ii) where the ADI is a **significant financial institution**, APS 180 for OTC and exchange-traded derivative transactions or long-settlement transactions. Where an ADI uses the adjusted current exposure method (CEM) under APS 180 and the transaction is collateralised, the ADI may also adjust the credit equivalent amount (CEA) by applying the comprehensive approach in Attachment G to this Prudential Standard;

    (b) second, the resulting exposure amount or EAD must be multiplied by the relevant risk weight applicable to the counterparty or exposure type.

21. For SFTs, including securities lending transactions, an ADI must calculate:

    (a) RWA arising from its exposure to the SFT counterparty, where EAD is calculated in accordance with Attachment G to this Prudential Standard and is multiplied by the relevant risk weight applicable to the SFT counterparty; and

    (b) the capital requirement for the credit risk or market risk inherent in any securities the ADI lends or posts as collateral, if that risk remains with the ADI.

Credit risk mitigation

22. Where multiple CRM techniques cover a single exposure, an ADI must divide the exposure into portions covered by each CRM technique. The RWA of each portion must be calculated separately, and then totalled. If credit protection provided by a single protection provider has differing maturities, they must also be subdivided into separate protected portions.

23. An ADI must not recognise additional CRM on exposures where the risk weight is mapped from an ECAI issue-specific credit rating, and that credit rating already incorporates the recognition of CRM.

24. An ADI must not recognise the use of CRM where the credit quality of the counterparty has a material positive correlation with the CRM technique used, or with any resulting residual risks (e.g. collateral in the form of securities issued by the counterparty to the credit exposure is considered to have a material positive correlation with the credit quality of the original counterparty).

25. To obtain capital relief through the use of a CRM technique, all documentation must be binding on all parties and legally enforceable in all relevant jurisdictions.

The ADI must have undertaken sufficient legal review to be satisfied of the legal enforceability of the CRM technique, and must undertake periodic reviews to confirm its ongoing enforceability.

Attachment A – Risk weights for property exposures

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

Standard property loans

2. A loan must meet all of the requirements set out in paragraphs 3 to 7 of this Attachment to be classified as standard.

3. An ADI must have unequivocal enforcement rights over the mortgaged property at all times, including a right to possession and power of sale in the event of default by the borrower. An ADI must reasonably consider that it would be able to realise the value of the property provided as security within a reasonable timeframe.

4. An ADI's exposure must be secured by a registered first mortgage over the property, or by a registered second mortgage which satisfies the following conditions:

   (a) the ADI must obtain the written consent of the first mortgagee for the second mortgage, and confirm the maximum outstanding amount of the loan secured by the first mortgage (including the maximum drawdown or limit of the facility) for LVR purposes;

   (b) the ADI must ensure that the amount secured by the first mortgage cannot be increased without being subordinate to the second mortgage;

   (c) the ADI, as second mortgagee, must be able to exercise its power of sale over the property independently of any other mortgagee over the property; and

   (d) where the sale of the property is not carried out by means of a public auction, the first mortgagee must be required to take reasonable steps to obtain a fair market value, or the best price that may be obtained in the circumstances, when exercising any power of sale (i.e. it is not possible for the first mortgagee to sell the property on its own at a discounted value to the detriment of the ADI).

5. An ADI must, prior to loan approval, appropriately document, assess and verify the ability of the borrower to meet their repayment obligations. This must, at a minimum, include:

   (a) consideration of the impact of higher interest rates on the ability of the borrower to repay;

(b) the application of the assessment in paragraph 5(a) of this Attachment to the loan being assessed for approval and all existing and ongoing debt commitments of the borrower(s), both secured and unsecured;

(c) for interest-only loans secured by residential property, an assessment of serviceability for the specific term over which principal-and-interest repayments apply, excluding the interest-only period; and

(d) where the repayment of a commercial property loan is dependent on the cash flows generated by the property through rental income, an assessment of the tenancy profile relative to the maturity of the loan.

Where an ADI's assessment does not result in a positive determination of the borrower's ability to meet their repayment obligations, an ADI must classify the loan as non-standard.

6. An ADI must appropriately value any property offered as security in accordance with paragraph 11 of this Attachment. With the exception of land acquisition, development and construction (ADC) exposures, the value of the property must not depend materially on the performance of the borrower.

7. All of the information required at loan origination and for monitoring purposes must be accurately documented and readily accessible to the ADI, including information on the ability of the borrower to repay and on the valuation of the property.

8. Property exposures that were originated prior to 1 January 2023, with no material change to loan terms and conditions subsequent to this date, do not need to satisfy the criteria set out in paragraph 5 of this Attachment to be classified as standard loans.

Loan-to-valuation ratio

9. The components of LVR must be prudently calculated in accordance with the requirements set out in paragraphs 10 and 11 of this Attachment.

10. The amount of the loan includes the outstanding loan amount (including accrued interest and fees) and any undrawn committed amount (as set out in Attachment C to this Prudential Standard), calculated gross of any provisions for defaulted exposures and other credit risk mitigants. If an ADI provides:

(a) multiple loans secured by the same property and they are sequential in ranking order (i.e. there is no intermediate interest from another lender), the loan amounts must be aggregated and treated as a single exposure for the purpose of calculating the LVR; or

(b) a loan that is secured by a second mortgage, the outstanding amount of the loan must be calculated as the sum of all claims on the borrower secured by both the first and second mortgages over the same property for the purpose of calculating the LVR.

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

11. The value of the property must be appraised independently using prudently conservative criteria, consistent with the requirements set out in APS 220.[6] If a market value can be determined, the valuation must not be higher than the market value.[7] For the purpose of calculating the property value:

    (a) the value of the property at origination must be maintained, unless:

        (i) an updated valuation is obtained as part of a new loan application process in relation to the mortgaged property;

        (ii) an event occurs that results in a likely permanent reduction in the property's value; or

        (iii) modifications are made to the property or contractual tenancy arrangements, that unequivocally increase its value, and an updated valuation is obtained which confirms the increase in value;

    (b) where a loan is secured by multiple properties, an ADI must use the aggregate value of the mortgaged properties for the purpose of calculating LVR; however, where a residential property exposure is secured by both residential and commercial properties, an ADI must apply a 40 per cent haircut to the value of any commercial property included in calculating LVR; and

    (c) for a reverse mortgage, where a borrower has been guaranteed a minimum share in the future sale proceeds of a mortgaged property, the calculation of the LVR for regulatory purposes must be adjusted by reducing the value of the mortgaged property by the quarantined percentage share.

12. For exposures secured by commercial property that were originated prior to 1 January 2023, an ADI may use the current valuation, rather than the value of the property at origination, for the purpose of paragraph 11(a) of this Attachment.

Credit risk mitigation

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

Residential property

14. A residential property exposure is an exposure where the predominant security is an immovable property that has the nature of a dwelling, and satisfies all

---

6 The valuation must be done independently from the ADI's mortgage acquisition, loan processing and loan decision process.

7 Where the loan is financing the purchase of property, the value of the property for LVR purposes must not be higher than the effective purchase price, except for non-arm's length transactions.

applicable laws and regulations enabling the property to be occupied for housing purposes. Residential property includes the following exposure types:

(a) 'Owner-occupied' refers to a loan for the purpose of housing, where the funds are used for a residential property that is occupied, or to be occupied, by the borrower(s) as their principal place of residence. Where the loan is for a residential property that is different to the residential property against which the loan is secured, this definition refers to the occupation status of the residential property for which the loan has been obtained (not the occupation status of the residential property used as security). It includes:

(i) a dwelling or residential land that is vacant while under construction, but that the borrower intends to occupy as a principal place of residence; and

(ii) a part-time residence that is the principal place of residence of the borrower(s).

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

(b) 'Principal-and-interest' refers to a loan on which interest is paid and principal is automatically amortised over the life of the loan.

(c) 'Other standard residential property' refers to any of the following exposures:

(i) loans for a purpose other than owner-occupation, including for investment or business purposes;

(ii) interest-only loans with an interest-only term of five years or less, where only interest is paid and principal is not automatically amortised; or

(iii) other loans that do not meet both of the criteria in paragraphs 14(a) and 14(b) of this Attachment.

Lenders' mortgage insurance

15. An ADI may reduce its capital requirement through the application of LMI, where the insurance:

(a) provides cover for all losses up to at least 40 per cent of the higher of the original loan amount and outstanding loan amount; and

(b) is provided by an eligible lenders' mortgage insurer, which means that:

(i) for the purposes of Level 1 Regulatory Capital, the lenders' mortgage insurer must be regulated by APRA; and

(ii) for the purposes of Level 2 Regulatory Capital, in the case of overseas subsidiaries of Australian ADIs, the lenders' mortgage insurer is regulated by an overseas prudential regulator.

Risk weights for standard residential property loans

16. An ADI must apply the risk weights in Table 1 to its residential property exposures that satisfy all of the conditions of a standard loan as set out in paragraphs 3 to 7 of this Attachment, based on their classification as an owner-occupied principal-and-interest or other standard residential property exposure, the application of eligible LMI and the exposure's LVR.

Table 1 Risk weights for standard loans

LVR (%)		Risk weight (%)						
		≤ 50	**50.01 - 60**	**60.01 - 70**	**70.01 - 80**	**80.01 - 90**	**90.01 - 100**	**> 100**
Owner-occupied principal-and-interest	**LMI**	20	25	30	35	40	55	70
	No LMI					50	70	85
Other standard residential property	**LMI**	25	30	40	45	50	70	85
	No LMI					65	85	105

17. An ADI may apply a risk weight of 35 per cent to residential property exposures that satisfy the conditions for inclusion within the Australian Government's Home Guarantee Scheme, and in respect of which the National Housing Finance and Investment Corporation has issued a guarantee certificate to the ADI. This capital treatment ceases to apply when:

(a) the guarantee certificate expires or is released in accordance with the terms of the Deed of Guarantee in respect of the First Home Loan Deposit Scheme or the Family Home Guarantee Scheme; or

(b) APRA determines that it no longer applies.

APRA may determine that this treatment may also be applied to a similar guarantee scheme that is offered by the Australian Government or an Australian State or Territory government.

Risk weights for non-standard residential property loans

18. An exposure that is secured by residential property but does not meet any of the requirements set out in paragraphs 3 to 7 of this Attachment, must be classified as a non-standard loan.

19. The following exposures must also be classified as non-standard loans:

    (a) interest only loans with an LVR greater than 80 per cent and an interest-only term that is specified in the loan contract as greater than five years or is of unspecified duration. The non-standard treatment applies while the loan remains on interest-only repayment terms. Exposures that meet the above criteria but are predominantly for business purposes may be excluded;

    (b) reverse mortgages, which are exposures that do not require principal-and-interest payments until termination of the facility. A risk weight of 50 per cent may only be applied to reverse mortgages where the criteria in paragraphs 3, 4, 6 and 7 of this Attachment are satisfied in addition to the LVR criteria in Table 2;

    (c) shared equity mortgages, where both the borrower and lender share in any gain or loss in the value of the mortgaged property; and

    (d) loans to self-managed superannuation funds.

20. An ADI must apply the risk weights in Table 2 to its non-standard loans secured by residential property, based on LVR (where applicable).

Table 2 Risk weights for non-standard loans

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

21. A loan secured by residential property which does not meet the criteria set out in paragraph 5 of this Attachment, and consequently must be classified as a non-standard loan, may be reclassified as a standard loan where the loan has been performing consecutively for the previous 36 months.

Commercial property

22. A commercial property exposure is a property exposure that is not a residential property exposure as defined in paragraph 14 of this Attachment, and is not land acquisition, development and construction as defined in paragraphs 27 and 28 of this Attachment.

Dependent on property cash flows

23. If the prospects for repayment of the exposure depend primarily on the cash flows generated by the asset or other real estate assets owned by the borrower, an ADI must apply the risk weights in Table 3 based on LVR and the classification of the loan as standard or non-standard.

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

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

Not dependent on property cash flows

24. If the servicing and repayment of a commercial property exposure does not meet the criteria for dependence as set out in paragraph 23 of this Attachment, an ADI must apply the risk weights in Table 4 based on counterparty type, LVR and the classification of the loan as standard or non-standard.

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

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

25. An exposure may be classified as 'commercial property exposures - not dependent on property cash flows' where an ADI has recourse to a borrower that meets all of the following criteria:

    (a) the borrower is a corporate entity that is managed by a recognised, professional and reputable management team;

    (b) the ADI's exposure to the borrower is not specifically or substantially financing limited recourse development projects;

    (c) the borrower has greater than $250 million in tangible assets, to which the ADI has unconditional recourse;

    (d) real estate assets are sufficiently diversified such that:

        (i) no single asset represents greater than 25 per cent of the borrower's real estate portfolio by value; and

        (ii) real estate assets are not concentrated in one particular specific geographic location; and

(e) for real estate operators or investors, tenants are sufficiently diversified such that no single tenant represents:

(i) greater than 25 per cent of portfolio net rental income for portfolios of retail shopping centres that typically require significant anchor tenants to attract specialty tenants; and

(ii) greater than 10 per cent of portfolio net rental income for all other portfolios of real estate assets (e.g. commercial offices, industrial buildings, hotels), with the exception of Government tenants.

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

Land acquisition, development and construction

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

28. All property exposures where the predominant property security is not fully completed must be included as ADC unless:

(a) the property is used predominantly for forest or agricultural purposes; or

(b) the loan is secured by residential property under construction, or by land upon which residential property will be constructed, where the property will be the primary residence of the borrower.

29. An ADI may apply a risk weight of 100 per cent to its ADC exposures secured by residential property if the following conditions are met:

(a) the exposure meets all of the requirements in paragraphs 3, 4, 6 and 7 of this Attachment;

(b) total debt to qualifying development costs are less than 75 per cent, where debt includes all debt facilities held by the borrower in relation to the underlying property;

(c) where the exposure to the borrower is greater than $5 million in aggregate for a single development, qualifying pre-sales for the underlying property are at least equal to 100 per cent of the total debt; and

(d) the ADI has a policy that defines qualifying pre-sales and qualifying development costs for the purpose of meeting the requirements under paragraph 29 of this Attachment.

30. An ADI must apply a risk weight of 150 per cent to all other ADC exposures.

Attachment B – Risk weights for non-property exposures

1. An ADI must risk-weight all exposures that are not property exposures according to the requirements detailed in this Attachment, with the exception of:

   (a) unsettled and failed transactions, which must be risk-weighted in accordance with Attachment D to this Prudential Standard; and

   (b) defaulted exposures, which must be risk-weighted in accordance with Attachment E to this Prudential Standard.

2. Where this Attachment requires an ADI to assign risk weights based on external credit ratings, an ADI must also comply with the requirements set out in Attachment F to this Prudential Standard.

Sovereign exposures

3. A sovereign exposure includes:

   (a) all exposures to Australian and overseas central and subnational governments, where a subnational government is defined as a government of a geographically defined part of a state which has powers to raise revenue and borrow money;

   (b) all exposures to the Reserve Bank of Australia and overseas central banks, where a central bank is defined as an entity which is responsible for overseeing and implementing the monetary policy of a state or group of states; and

   (c) all exposures to institutions and multilateral development banks eligible for a zero per cent risk weight.[8]

4. An ADI must apply the risk weights in Table 5 to its sovereign exposures, based on the external credit rating of the sovereign, with the exception of those sovereign exposures eligible for a zero per cent risk weight under paragraph 3(c) of this Attachment.

[8] For the purpose of paragraph 3(c) of this Attachment, the following institutions may be risk-weighted at zero per cent: the Bank for International Settlements; the International Monetary Fund; the European Central Bank; the European Union; the European Stability Mechanism; the European Financial Stability Facility; the World Bank Group comprising the International Bank for Reconstruction and Development, the International Finance Corporation, the Multilateral Investment Guarantee Agency and the International Development Association; the Asian Development Bank; the African Development Bank; the European Bank for Reconstruction and Development; the Inter-American Development Bank; the European Investment Bank; the European Investment Fund; the Nordic Investment Bank; the Caribbean Development Bank; the Islamic Development Bank; the Council of Europe Development Bank; the International Finance Facility for Immunization; and the Asian Infrastructure Investment Bank.

Table 5 Risk weights for sovereign exposures

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

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

Domestic public sector entities

6. An ADI must apply the risk weights in Table 6 to its exposures to domestic public sector entities (PSEs) that do not meet the definition of a sovereign exposure, based on the external credit rating of the domestic PSE.

Table 6 Risk weights for domestic PSEs

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

Bank exposures

7. An exposure to a bank counterparty includes all exposures, other than equity or subordinated debt, to an ADI or overseas bank. It includes any exposures to multilateral development banks that are not eligible to be risk-weighted at zero per cent in accordance with paragraph 3(c) of this Attachment.

8. An ADI must apply the risk weights in Table 7 to its bank exposures, based on the external credit rating of the bank.

Table 7 Risk weights for bank exposures

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

9. For the purpose of Table 7, an ADI may apply the short-term exposure risk weights to its bank exposures, where the exposure:

   (a) has an original maturity of three months or less; or

(b) arises from the movement of goods across national borders, with an original maturity of six months or less.[9]

10. Unrated bank exposures must be risk-weighted as the higher of:

(a) 20 per cent for short-term exposures and 50 per cent for long-term exposures; and

(b) the risk weight applicable to exposures to the sovereign of the country where the bank counterparty is incorporated.

The sovereign risk-weight floor does not apply to short-term self-liquidating, trade-related contingent items that arise from the movement of goods.[10]

11. An ADI must apply the risk weights in Table 8 to short-term bank exposures with an issue-specific external credit rating.

Table 8 Risk weights for bank exposures (short-term issue-specific credit ratings)

Credit rating grade (short term)	**1**	**2**	**3**	**4**
Risk weight (%)	20	50	100	150

12. If an ADI has a bank exposure with an issue-specific short-term external credit rating that maps to a credit rating grade:

(a) that requires a higher risk weight than would be assigned under Table 7 (short-term exposure), then an ADI must risk-weight the exposure in accordance with Table 8 and not Table 7;

(b) of 2 or 3 under Table 8, then all unrated short-term exposures to that counterparty must be risk-weighted at 100 per cent; and

(c) of 4 under Table 8, then all unrated exposures to that counterparty, whether they are short-term or long-term exposures, must be risk-weighted at 150 per cent.

13. When assigning risk-weights to bank exposures based on external credit ratings, an ADI must not use ratings that incorporate assumptions of implicit government support.

---

9 This may include on-balance sheet exposures such as loans and off-balance sheet exposures such as self-liquidating trade-related contingent items.

10 For this purpose, short-term refers to an exposure with a maturity less than 12 months.

Covered bonds

14. An ADI may apply the risk weights in Table 9 to its covered bond exposures with an issue-specific external credit rating, where the requirements set out in paragraphs 15 and 16 of this Attachment are met.

Table 9 Risk weights for rated covered bond exposures

Credit rating grade	**1**	**2, 3**	**4, 5**	**6**
Risk weight (%)	10	20	50	100

15. An ADI may apply the risk weights in Table 9 where:

    (a) the cover pool includes only the following assets:

        (i) loans to, or guaranteed by, sovereigns or domestic PSEs;

        (ii) loans to, or guaranteed by, banks that qualify for a risk weight of 30 per cent or lower in accordance with paragraphs 8 to 10 of this Attachment; however, such assets cannot exceed 15 per cent of the cover pool;

        (iii) residential property exposures that meet the requirements in paragraphs 3 to 7 of Attachment A to this Prudential Standard for covered bonds issued in Australia, and as defined by the relevant supervisory authority for covered bonds issued in other jurisdictions, with an LVR equal to or less than 80 per cent; and

        (iv) commercial property exposures that meet the requirements in paragraphs 3 to 7 of Attachment A to this Prudential Standard for covered bonds issued in Australia, and as defined by the relevant supervisory authority for covered bonds issued in other jurisdictions, with an LVR equal to or less than 60 per cent;

    (b) the nominal value of the cover pool exceeds the nominal outstanding value of the covered bond by at least 10 per cent; and

    (c) the conditions set out in this paragraph are satisfied at the time of issuance, and at all times throughout the remaining maturity of the covered bond.

16. An ADI must be able to demonstrate to APRA that, at a minimum, the following information is available to the ADI on at least a semi-annual basis:

    (a) the value of the cover pool and outstanding covered bonds;

    (b) the geographical distribution and type of cover assets, loan size, interest rate and currency risks;

(c) the maturity structure of assets in the cover pool and of the covered bonds; and

(d) the percentage of loans that are 90 days or more past-due.

17. Where a covered bond is unrated or does not meet the requirements set out in paragraphs 15 and 16 of this Attachment, an ADI must treat the covered bond as a bank exposure and apply the risk weights in Table 7.

Corporate exposures

18. An exposure to a corporate counterparty includes all exposures to incorporated entities, associations, partnerships, proprietorships, trusts, funds and other entities that do not meet the definition of any other asset class. Exposures to financial institutions, excluding banks but including insurance companies or securities companies, must be treated as corporate exposures. Exposures to equity or subordinated debt, or exposures through a third party as detailed in paragraph 41 of this Attachment, must not be included as corporate exposures.

General corporate – rated exposures

19. An ADI must apply the risk weights in Table 10 to its general corporate exposures with an external credit rating.

Table 10 Risk weights for general corporate exposures

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

20. An ADI must apply the risk weights in Table 11 to short-term general corporate exposures with an issue-specific external credit rating.

Table 11 Risk weights for general corporate exposures (short-term issue-specific credit ratings)

Credit rating grade (short-term)	**1**	**2**	**3**	**4**
Risk weight (%)	20	50	100	150

21. If an ADI has a general corporate exposure with an issue-specific short-term external credit rating mapping to a credit rating grade of 4 under Table 11, then all unrated exposures to that counterparty, whether they are short-term or long-term exposures, must be risk-weighted at 150 per cent.

General corporate – unrated small- and medium-sized enterprise exposures

22. An exposure to an SME is an exposure to a corporate counterparty with total consolidated annual revenue of less than $75 million. Where an ADI has an

exposure to an SME that is part of a corporate group, it may be treated as an SME exposure provided the total consolidated annual revenue for the group is less than $75 million. Where a corporate counterparty's total consolidated annual revenue cannot be determined, and the exposure is less than $5 million, the ADI may treat the exposure as SME.

23. An ADI must apply the risk weights in Table 12 to its unrated SME exposures.

Table 12 Risk weights for unrated SME exposures

	Risk weight (%)
SME retail	75
SME corporate	85

24. To be risk-weighted as SME retail, the following criteria must be satisfied:

(a) the exposure is in the form of a small business lending facility or commitment. Derivatives and other securities such as bonds and equities, and exposures secured by residential property are excluded from this category; and

(b) the maximum aggregated exposure to the SME counterparty is less than $1.5 million. For this purpose:

(i) aggregated exposure means the gross amount, excluding the application of any credit risk mitigation. For off-balance sheet exposures, the gross amount must be calculated after applying CCFs; and

(ii) the SME counterparty means either a single SME, or where the SME forms part of a corporate group, the broader group.

General corporate – other

25. For all other unrated general corporate exposures that are not treated as SME, an ADI must either:

(a) assign a 100 per cent risk-weight to all exposures; or

(b) assign an 85 per cent risk-weight to exposures to 'investment grade' corporates and a 110 per cent risk weight to exposures to 'non-investment grade' corporates where the ADI has in place an APRA approved methodology that differentiates between 'investment grade' and 'non-investment grade' corporates.

An investment grade general corporate refers to a general corporate entity that has adequate capacity to meet its financial commitments in a timely manner and its ability to do so is assessed to be robust against adverse changes in the economic cycle and business conditions. When assessing whether a general corporate exposure is investment grade or non-investment grade, an ADI must assess the

general corporate entity against the investment grade definition taking into account the complexity of its business model, performance against industry and peers, and risks posed by the entity's operating environment. An ADI must have sufficient information to conduct adequate due diligence for the assessment of whether the corporate entity is investment grade.

Specialised lending

26. A corporate exposure must be classified as a specialised lending exposure if it possesses the following characteristics, either in legal form or economic substance:

    (a) the exposure satisfies the definition of object finance, project finance or commodities finance as set out in paragraph 27 of this Attachment, is not a property exposure and is not secured by derivatives or other securities such as bonds or equities;

    (b) the exposure is typically to an entity that was created specifically to finance or operate physical assets;

    (c) other than the income that it receives from the assets being financed, the borrowing entity has little or no other material assets or activities, and therefore has little or no independent capacity to repay the obligation;

    (d) the terms of the obligation give the ADI a substantial degree of control over the assets and the income that it generates; and

    (e) as a result of the characteristics detailed in 26(a) to 26(d) of this paragraph, the primary source of repayment of the obligation is the income generated by the assets rather than the independent capacity of a broader commercial enterprise.

27. The specialised lending asset class includes the following three sub-classes:

    (a) project finance, refers to the method of funding in which the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security for the loan;

    (b) object finance, refers to the method of funding the acquisition of equipment where the repayment of the loan is dependent on the cash flows generated by the specific assets that have been financed and pledged or assigned to the lender; and

    (c) commodities finance, refers to short-term lending to finance reserves, inventories, or receivables of exchange-traded commodities, where the loan will be repaid from the proceeds of the sale of the commodity and the borrower has no independent capacity to repay the loan.

28. Where an issue-specific external credit rating is available for a specialised lending exposure, an ADI must apply the risk weights in Table 10.

29. An ADI must apply the risk weights in Table 13 to its unrated specialised lending exposures, including any exposures with an issuer-specific external credit rating.

Table 13 Risk weights for unrated specialised lending exposures

	Risk weight (%)
Project finance	110
Object and commodities finance	100

Retail exposures

30. A retail exposure is any exposure to one or more individuals (that is, natural persons), that is not a property exposure or margin lending exposure.

31. An ADI must apply the risk weights in Table 14 to its retail exposures, based on the product type.

Table 14 Risk weights for retail exposures

	Risk weight (%)
Credit card exposures	75
Other retail exposures	100

Margin lending exposures

32. An ADI must apply a risk weight of 20 per cent to margin lending exposures secured by eligible financial collateral. Where a margin loan is secured by other collateral, an ADI must apply a risk weight of 100 per cent to its exposure.

Subordinated debt

33. Subordinated debt includes any facility that is expressly subordinated to another facility, or has the effect of conveying economic subordination to another facility.[11] Subordinated debt that is not required to be deducted from regulatory capital under APS 111 must be risk weighted at 150 per cent.

Equity

34. Equity exposures must be defined on the basis of the economic substance of the instrument. Equity exposures include both direct and indirect ownership interests,[12] whether voting or non-voting, in the assets and income of entities,

[11] Subordinated debt which is structured for the purpose, or has the effect, of conveying the economic substance of equity ownership, must be treated as an equity exposure.

[12] Indirect equity interests include holdings of derivative instruments tied to equity interests and holdings in corporations, partnerships, limited liability companies, trusts or other types of entities

including commercial enterprises and financial institutions. An instrument is considered to be an equity exposure if it meets the following criteria:

(a) it is irredeemable, in that the return of invested funds can be achieved only by the sale of the investment, the sale of the rights to the investment or by the liquidation of the issuer;

(b) it does not embody an obligation of the issuer; and

(c) it conveys a residual claim on the assets or income of the issuer.

35. Debt obligations and other securities, units in trusts, derivatives or other instruments which are structured for the purpose, or have the effect, of conveying the economic substance of equity ownership must be treated as equity exposures. This includes options and warrants on equities and short positions in equity securities. In addition, if a debt instrument is convertible into equity at the option of an ADI, it should be treated by the ADI as equity on conversion. If such an instrument is convertible at the option of the issuer or automatically by the terms of the instrument, it should be treated by the ADI as equity from inception.

36. Equities that are recorded as a loan but arise from a debt/equity swap made as part of the orderly realisation or restructuring of the debt must be treated as an equity exposure.

37. Instruments with a return directly linked to equities must be treated as equity exposures.

38. An ADI must risk-weight equity exposures that are not required to be deducted from Regulatory Capital under APS 111 at:

(a) 250 per cent if the equity exposure is listed on a recognised exchange, or where the equity exposure is to the ADI's banking or insurance subsidiary at Level 1;[13] and

(b) 400 per cent if the equity exposure is not listed on a recognised exchange.

Leases

39. Lease exposures include all lease and asset finance exposures, irrespective of the counterparty type, and include exposures generated by the leasing of right-of-use assets. For lease exposures, excluding residual value risk, an ADI must apply the risk weight of the counterparty, as specified in this Attachment.

---

that issue ownership interests and are engaged principally in the business of investing in equity instruments.

13 The risk-weighting of equity exposures in banking or insurance subsidiaries at Level 1 is subject to the deduction threshold detailed in Attachment D to APS 111.

40. Where an ADI is exposed to residual value risk, such as when it acts as the lessor in operating leases, it must measure the aggregate residual value and apply the risk weights in Table 15 to the residual value of its leased assets.

Table 15 Risk weights for residual value under lease exposures

	Risk weight (%) applying to the portion of aggregate residual value ≤ 10% of Common Equity Tier 1 capital	**Risk weight (%) applying to the portion of aggregate residual value > 10% of Common Equity Tier 1 capital**
Exposures to residual value	100	250

Exposures through a third party

41. An ADI must apply a risk weight of 150 per cent to credit exposures originated through a third party, where the ADI:

(a) does not undertake the credit assessment and approval of the underlying borrower under its own credit risk policies and processes;

(b) is unable to administer the workout or default processes; and

(c) does not have direct recourse to the third party or underlying borrower in the event of default.

The risk weight prescribed in this paragraph must be applied to all such arrangements irrespective of the characterisation of the third party or underlying borrower.

Other exposures

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

Table 16 Risk weights for other exposures

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

Risk weight multiplier for certain exposures with currency mismatch

43. For exposures originated after 1 January 2023, an ADI must apply a 1.5 times multiplier to the applicable risk weight for any unhedged retail or residential property exposure to individuals, where the lending currency differs from the currency of the borrower's source of income.

44. An unhedged exposure is an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk resulting from the currency mismatch between the currency of the borrower's income and the currency of the loan. A natural hedge exists where the borrower receives foreign currency income that matches the currency of a given loan. A financial hedge generally includes a legal contract with a financial institution. For the purpose of the application of the multiplier, an ADI may only treat an exposure as hedged where the natural or financial hedge covers at least 90 per cent of the loan repayment amount.

Attachment C – Off-balance sheet commitments

1. A commitment is any arrangement that has been offered by the ADI and accepted by the borrower to extend credit, purchase assets or issue credit substitutes. It includes SFTs.

2. A commitment includes any arrangement that can be unconditionally cancelled by the ADI at any time without prior notice to the borrower. It also includes any such arrangement that can be cancelled by the ADI if conditions set out in the facility documentation are not met, including conditions that must be met by the borrower or third parties (conditions precedent) prior to any initial or subsequent drawdown under the arrangement.

3. Where an ADI enters into an arrangement that meets all of the following conditions, it may be excluded from the definition of commitment:

   (a) the ADI receives no fees or commissions to establish or maintain the arrangement;[14]

   (b) the borrower is required to apply to the ADI for the initial and each subsequent drawdown;

   (c) the ADI has full authority, regardless of the fulfilment by the borrower of the conditions set out in the facility documentation, over the execution of each drawdown;[15]

   (d) the ADI's decision on the execution of each drawdown is made only after assessing the creditworthiness of the borrower immediately prior to drawdown. This assessment of creditworthiness must be undertaken by an independent party and, at a minimum, include confirmation of the borrower's good credit standing and that no material adverse information has arisen subsequent to the limit approval or the most recent credit review that would affect the borrower's creditworthiness;[16] and

   (e) the borrower is a corporate counterparty that is closely monitored on an ongoing basis, and is not an SME retail borrower.

4. In respect of margin lending, the committed amount is the maximum amount that the borrower can draw down based on the terms of the loan (such as the notional credit limit and the maximum allowable LVR) and the value of the security underlying the loan. However, if an ADI does not adjust the credit limit before a

---

14 External valuation fees, external legal fees, external advisory fees, and the collection of fees by an ADI on behalf of a third-party service provider (e.g. collateral agent) do not vitiate this condition.

15 The terms of the arrangement must explicitly confer sole discretion on the ADI to control drawdown.

16 For this purpose, independent party refers to a party independent of the borrower's relationship manager. The independent party should sit within the risk function of the business unit or the centralised risk function. Operational or back office teams that perform documentary checks are not adequate for this purpose.

drawdown in response to a decline in security value, then the ADI must use the original amount in the loan contract that is independent of the security value.

5. Where a commitment exists, an ADI must multiply the committed but undrawn amount of the exposure by the relevant CCF in Table 17, and then risk-weight the exposure according to the relevant requirements set out in Attachments A, B and D to this Prudential Standard.

Table 17 CCFs

Transaction type	CCF (%)
Direct credit substitutes	100
Sale and repurchase agreements and asset sales with recourse[17]	100
Lending of securities or posting of securities as collateral	100
Forward asset purchases, forward deposits and partly paid shares and securities[18]	100
Other off-balance sheet items that are credit substitutes	100
Unsettled securities, commodities and foreign exchange transactions accounted for at settlement date	100
Other commitments with certain drawdown	100
Note issuance and revolving underwriting facilities	50
Performance-related contingencies	50
Other commitments	40
Short-term self-liquidating trade letters of credit arising from the movement of goods[19]	20
Intraday limits	0
Irrevocable standby commitments under industry support arrangements	0

6. Where an ADI has given a commitment to provide an off-balance sheet exposure, it may apply the lower of the CCFs applicable to the commitment and the off-balance sheet exposure.

[17] These items must be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.

[18] These items must be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.

[19] For the purpose of this item, short-term means a maturity less than 12 months.

Attachment D – Unsettled and failed transactions

1. Delivery-versus-payment (DvP) transactions include any transaction settled through a system which provides for the simultaneous exchange of securities or commodities for cash, and expose an ADI to the risk of loss on the difference between the transaction valued at the agreed settlement price and the transaction valued at the current market price. This includes payment-versus-payment transactions.

2. An ADI must apply the risk weights in Table 18 to all DvP transactions, excluding SFTs, which remain unsettled after their due delivery dates. The amount that must be multiplied by the relevant risk weight is the positive current exposure amount of the DvP transaction, i.e. the difference between the agreed settlement price of the transaction and the current market price of the transaction where this would result in a loss to the ADI.

Table 18 Risk weights for DvP transactions

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

3. An ADI must hold Regulatory Capital against a non-DvP transaction which exposes the ADI to the risk of loss on the full amount of cash paid or deliverables delivered, where:

   (a) it has paid for debt instruments, equities, foreign currencies or commodities before receiving them or it has delivered debt instruments, equities, foreign currencies or commodities before receiving payment for them; and

   (b) in the case of a cross-border transaction, one day or more has elapsed since it made that payment or delivery.

4. An ADI must calculate the capital requirement for a non-DvP transaction as follows:

   (a) from the business day after the ADI has made its payment or delivery for up to and including four business days after the counterparty payment or delivery is due, the ADI must treat the transaction as an exposure; and

   (b) from five business days after the ADI has made its payment or delivery until extinction of the transaction, the ADI must apply a 1250 per cent risk weight to the value transferred plus the positive current exposure amount.

5. Where a non-DvP transaction must be treated as an exposure in accordance with paragraph 4(a) of this Attachment, an ADI may:

(a) apply the relevant risk weight based on the counterparty as detailed in Attachment B to this Prudential Standard; or

(b) where exposures are not material, apply a 100 per cent risk weight provided that all such exposures are risk-weighted consistently.

Attachment E – Defaulted exposures

1. Where an exposure is in default, an ADI must apply the risk weights in Table 19 or Table 20 to the exposure amount, net of any provisions for defaulted exposures and partial write-offs.

2. An ADI may recognise eligible credit risk mitigation in calculating the exposure amount.

Risk weights for residential property exposures

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

Table 19 Risk weights for defaulted residential property exposures

	Risk weight (%)
Owner-occupied principal-and-interest with LMI	80
Owner-occupied principal-and-interest without LMI	100
Other standard residential property with LMI	95
Other standard residential property without LMI	120
Non-standard loans	150

Risk weights for other defaulted exposures

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

Table 20 Risk weights for other defaulted exposures

	Risk weight (%)
Provisions for the defaulted exposure are ≥ 20 per cent of the outstanding exposure amount	100
Provisions for the defaulted exposure are < 20 per cent of the outstanding exposure amount	150

Attachment F – External credit ratings

1. An ADI may only use the solicited ratings of ECAIs to determine the credit rating grades that correspond to the risk weights for counterparties and exposures.[20] Ratings must be used consistently for each type of exposure.

2. An ADI must only use an ECAI rating that takes into account and reflects the entire amount of credit risk exposure that the ADI has with regard to all amounts owed to it.

3. Where an ADI uses the ratings of ECAIs, it must perform due diligence to ensure that the external ratings appropriately and conservatively reflect the creditworthiness of the counterparty. If the due diligence analysis reflects higher risk characteristics than that implied by the exposure's external rating, an ADI must assign a risk weight at least one bucket higher than that determined by the external rating. Due diligence analysis must not result in the application of a lower risk weight than that determined by the external rating.

4. An ADI must not use credit ratings for one entity within a corporate group to determine the risk weight for other entities within the same group. If a rated entity has guaranteed another entity's exposure to the ADI, the guarantee may be recognised for risk-weighting purposes if the criteria set out in Attachment I to this Prudential Standard are satisfied.

Issue-specific and issuer ratings

5. Where an ADI has an exposure with an issue-specific rating, the risk weight of the exposure must be assigned based on this rating. Where an exposure does not have an issue-specific rating, the ADI must apply the following requirements:

   (a) where the counterparty has a specific rating for an issued debt, but the ADI's exposure is not an investment in that particular debt, a credit rating which maps to a risk weight lower than that which applies to an unrated exposure may only be applied if the exposure ranks senior or *pari passu* in all respects to the rated debt issue. If the exposure does not rank senior or *pari passu* with the rated debt issue, then the ADI must treat the exposure as unrated and apply the corresponding risk weight;

   (b) where the counterparty has an issuer rating, only senior exposures to that counterparty may be assigned a risk weight that corresponds to the issuer rating. If either the issuer or a single issue has a rating grade that maps to a risk weight higher than that applied to unrated exposures, then an exposure to that counterparty which ranks *pari passu* or is subordinated to either the senior unsecured issuer rating or the exposure with a low credit rating grade

[20] A solicited rating is a rating that has been initiated and paid for by the issuer or rated counterparty or a commercial associate of the issuer or rated counterparty. Sovereign exposures are excluded from the requirement to use solicited ratings.

must be assigned the same risk weight as is applicable to the low credit rating grade; and

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

Multiple assessments

6. Where a counterparty has multiple ECAI general issuer ratings, or where an issue has multiple ECAI issue-specific ratings and these ratings correspond to multiple credit rating grades, an ADI must apply the following requirements:

(a) where there are two ratings that correspond to different credit rating grades, the credit rating grade that corresponds to the higher risk weight must be used; or

(b) where there are three or more ratings that correspond to different credit rating grades, the credit rating grades corresponding to the two lowest risk weights must be referred to and the higher of those two risk weights must be used.

Domestic and foreign currency exposures

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

Mapping of credit rating grades

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

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

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

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

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

Credit rating grade	S&P Global Ratings	Moody's Ratings	Fitch Ratings	Morningstar DBRS
1	A-1	P-1	F-1	R-1
2	A-2	P-2	F-2	R-2
3	A-3	P-3	F-3	R-3
4	Others	Others	Others	Others

Attachment G – Collateralised transactions

1. This Attachment specifies how an ADI:

   (a) may apply credit risk mitigation to transactions secured by received collateral, to reduce its exposure amount for the purpose of calculating its Regulatory Capital requirement; and

   (b) must determine the EAD for SFTs or, for ADIs that use the simple approach, the risk weights.

2. In this Attachment:

   (a) 'received collateral' refers to eligible financial collateral (as defined in paragraphs 14 or 22 of this Attachment) that an ADI receives from the counterparty in a transaction, including where the counterparty has lent those securities to the ADI, or the transaction is a reverse repurchase agreement from the ADI's perspective; and

   (b) 'posted collateral' refers to collateral that an ADI posts to the counterparty in a transaction, including where the ADI has lent those securities to the counterparty, or the transaction is a repurchase agreement from the ADI's perspective.

3. An ADI must select either the simple approach or the comprehensive approach and apply that approach consistently to all of its banking book exposures for which it has received collateral. An ADI that is approved to use the internal ratings-based approach to credit risk is not permitted to use the simple approach.

4. For trading book exposures, an ADI must use the comprehensive approach where it has received collateral from the counterparty.

5. Where an ADI acting as an agent in a SFT provides a guarantee that its principal will perform its obligations, the risk to the ADI is the same as if the ADI had entered into the transaction as the principal. In such circumstances, the ADI must calculate a Regulatory Capital requirement as if it were the principal.

Minimum conditions for collateralised transactions

6. There must be a contract between the ADI and the party lodging received collateral which establishes the ADI's direct, explicit, irrevocable and unconditional recourse to the received collateral. In the case of cash collateral, this may include a contractual right of set-off on credit balances, but a common law right of set-off is insufficient on its own to satisfy this condition.

7. An ADI must take all steps necessary to obtain and maintain an enforceable security interest in the received collateral. The legal mechanism by which collateral is pledged or transferred must allow the ADI the right to liquidate or take legal possession of the received collateral in a timely manner. An ADI must have clear and robust procedures for the timely liquidation of collateral to ensure

that any legal conditions required for declaring the default of the counterparty and liquidating the received collateral are observed.

8. In the event of the counterparty's default, any requirement on the ADI to serve notice on the party lodging the received collateral must not unnecessarily impede the ADI's recourse to the received collateral.

9. Where posted or received collateral is held by a custodian or a third party, the ADI must take reasonable steps to ensure that the custodian or third party segregates the collateral from other assets.

10. Where the received collateral is lodged with an overseas branch of the ADI, the branch holding the collateral must be bound to act in accordance with the agreement between the ADI and the party lodging the received collateral.

11. Where the received collateral is lodged by a third party, that third party must indemnify or guarantee the performance of the counterparty's obligations (or those of the party on which a claim is held) to the ADI. The ADI must ensure that the indemnity or guarantee is legally enforceable (e.g. that it will not fail for lack of consideration).

12. An ADI must ensure that sufficient resources are devoted to the orderly operation of margin agreements with OTC derivative and securities-financing counterparties, as measured by the timeliness and accuracy of its outgoing calls and response time to incoming calls. An ADI must have collateral risk management policies in place to control, monitor and report:

    (a) the risk to which margin agreements expose it, such as the volatility and liquidity of the securities exchanged as collateral;

    (b) the concentration risk to particular types of collateral;

    (c) the re-use of collateral (both cash and non-cash) including the potential liquidity shortfalls resulting from the re-use of collateral received from counterparties; and

    (d) the surrender of rights on collateral posted to counterparties.

The simple approach

13. For received collateral to be recognised under the simple approach, it must be pledged for at least the life of the exposure (i.e. maturity mismatches are not permitted) and be marked-to-market and revalued with a minimum frequency of six months. The release of received collateral by the ADI must be conditional upon the repayment of the exposure. Received collateral may be reduced in proportion to the amount of the reduction in the exposure amount.

Eligible financial collateral under the simple approach

14. An ADI using the simple approach may only recognise the following items as eligible financial collateral:

(a) cash collateral (cash, certificates of deposit and bank bills issued by the ADI) on deposit with the ADI;[21]

(b) gold bullion;

(c) debt securities rated by an ECAI that have a credit rating grade of either:

(i) four (or better) for long-term securities issued by sovereigns;[22] or

(ii) three (or better) for short-term or long-term securities issued by other counterparties;

(d) debt securities not rated by an ECAI where:

(i) the securities are issued by a bank as senior debt and are listed on a recognised exchange;

(ii) all rated issues of the same seniority by the issuing bank have a long-term or short-term credit rating grade of at least three; and

(iii) the ADI holding the security has no information suggesting that the security justifies a rating below this level;

(e) senior securitisation exposures, as defined in APS 120, with an external credit rating grade of one;

(f) units in a listed or unlisted trust where:

(i) the unit price of the trust is publicly quoted on a daily basis;

(ii) the trust is limited to investing in the instruments detailed in paragraphs 14(a) to 14(e) of this Attachment;[23] and

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

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

Risk weights under the simple approach

16. Under the simple approach, the portion of an exposure that is secured by received collateral may be risk-weighted according to the risk weight of the received

---

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

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

23 The use of derivative instruments by a trust to hedge investments listed in paragraphs 14(a) to 14(e) of this Attachment would not prevent units in the trust from being recognised as eligible collateral.

collateral. The risk weight on that portion is subject to a floor of 20 per cent, except under the conditions specified in paragraphs 18 to 20 of this Attachment. The unsecured portion of an exposure must be risk-weighted according to the risk weight applicable to the original counterparty.

17. Where cash on deposit, certificates of deposit and bank bills issued by the ADI are held as received collateral at a third-party bank in a non-custodial arrangement, and are pledged or assigned to the ADI and the pledge or assignment is unconditional and irrevocable, the exposure amount covered by the received collateral may be assigned the risk weight of the third-party bank, determined in accordance with Attachment B to this Prudential Standard.

18. A zero per cent risk weight may be applied to collateralised transactions where the exposure and the collateral are denominated in the same currency and either:

    (a) the collateral is cash on deposit as defined in paragraph 14(a) of this Attachment; or

    (b) the collateral is in the form of sovereign securities eligible for a zero per cent risk weight as detailed in Attachment B to this Prudential Standard, and its market value has been discounted by 20 per cent.

19. SFTs that fulfil all of the following conditions may be risk-weighted at 10 per cent, or at zero per cent where the counterparty is a core market participant as defined in paragraph 20:

    (a) both the exposure and the collateral are cash, or a sovereign security qualifying for a zero per cent risk weight as set out in Attachment B to this Prudential Standard;

    (b) both the exposure and the collateral are denominated in the same currency;

    (c) either the transaction is overnight, or both the exposure and the collateral are marked-to-market daily and are subject to daily remargining;

    (d) following a counterparty's failure to remargin, the time between the last mark-to-market before the failure to remargin and the liquidation of the collateral is no more than four business days;

    (e) the transaction is settled across an established settlement system for that type of transaction;

    (f) the documentation for the transaction is standard market documentation;

    (g) the documentation for the transaction specifies that if the counterparty fails to satisfy an obligation to deliver cash, securities or a margin call, or otherwise defaults, the transaction is immediately terminable; and

    (h) upon any default event, regardless of whether the counterparty is insolvent or bankrupt, the ADI has an unequivocal, legally enforceable right to immediately seize and liquidate the collateral.

20. The following entities are core market participants:

    (a) the Australian Government and the Reserve Bank of Australia;

    (b) sovereigns that qualify for a zero per cent risk weight in accordance with Attachment B to this Prudential Standard;

    (c) banks;

    (d) other financial institutions (including insurance companies) eligible for a 20 per cent risk weight as set out in Attachment B to this Prudential Standard; and

    (e) qualifying central counterparties, as defined in APS 180.

The comprehensive approach

21. An ADI using the comprehensive approach may take into account the risk mitigating effects of any eligible collateral, in calculating the EAD for each counterparty.

Eligible financial collateral under the comprehensive approach

22. Under the comprehensive approach, eligible financial collateral is limited to:

    (a) collateral items listed in paragraph 14 and cash collateral included in paragraph 17 of this Attachment;

    (b) equities (including convertible bonds) that are included in a main index or listed on a recognised exchange; and

    (c) units in trusts that meet the conditions of paragraph 14(f) of this Attachment and that invest in the items detailed in paragraphs 22(a) or 22(b) of this Attachment.

Calculation of Regulatory Capital for collateralised transactions

23. For a collateralised transaction under the comprehensive approach, including SFTs, an ADI must adjust EAD as follows:

$$E^* = max\left\{0, \left[E' - \sum_i C_i \times (1 - H_i A - H_{fx,i} A)\right]\right\}$$

where:

E^* is the adjusted EAD

E' is $\sum_j E_j \times (1 + H_j A)$ where E_j is the EAD of the j-th item of exposure or posted collateral under the transaction, prior to haircuts or adjustment for received collateral. For OTC derivatives to which the ADI applies the adjusted CEM (refer to Attachment E to APS 180),

E' is the credit equivalent amount of the OTC derivative without adjustment for the impact of collateral

H_j is the haircut appropriate to the *j*-th item of exposure or posted collateral under the transaction, calculated in accordance with paragraph 28 of this Attachment

C_i is the current value of the *i*-th item of received collateral under the transaction, adjusted for any maturity mismatch in accordance with paragraphs 24 to 27 of this Attachment

H_i is the haircut appropriate to the *i*-th item of received collateral under the transaction, calculated in accordance with paragraph 28 of this Attachment

$H_{fx,i}$ is the haircut appropriate for currency mismatch between the exposure and the *i*-th item of received collateral under the transaction, calculated in accordance with paragraph 29 of this Attachment

A is the margining frequency adjustment factor determined in accordance with paragraph 32 of this Attachment.

Collateral maturity mismatch

24. A maturity mismatch exists where the residual maturity of the term of lodgement of the collateral is less than the maturity of the exposure covered by the collateral.

25. Where there is a maturity mismatch, the collateral may only be recognised where the original maturity of the term of lodgement of the collateral is greater than or equal to 12 months and the residual maturity is greater than or equal to 3 months.

26. For the purpose of determining maturity:

    (a) the effective maturity of the underlying exposure must be calculated using the longest possible remaining time before the counterparty is scheduled to fulfil its obligation; and

    (b) for the collateral, an ADI must take into account any clause or incentive within the documentation supporting the transaction that may reduce its term of lodgement so that the shortest possible effective maturity is used.

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

$$C = P \times \frac{t - 0.25}{T - 0.25}$$

where:

C = value of the collateral adjusted for maturity mismatch

P = collateral amount

t = min (T, residual maturity of the term of lodgement of the collateral) expressed in years

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

Supervisory haircuts

28. An ADI must use the supervisory haircuts set out in Table 23 to determine the haircuts for the collateral (H_i) and the exposure (H_j).

Table 23 Supervisory haircuts

Credit rating grade for debt securities	**Residual maturity**	**Sovereign (%)**	**Other issuer[24] (%)**	**Securitisation exposure[25] (%)**
1 (long- and short-term)	≤ 1 year	0.5	1	2
	> 1 year, ≤ 3 years	2	3	8
	> 3 years, ≤ 5 years		4	
	> 5 years, ≤ 10 years	4	6	16
	> 10 years		12	
2-3 (long- and short-term) and unrated bank securities[26]	≤ 1 year	1	2	Not eligible
	> 1 year, ≤ 3 years	3	4	
	> 3 years, ≤ 5 years		6	
	> 5 years, ≤ 10 years	6	12	
	> 10 years		20	
4 (long-term)	All	15	Not eligible	
Main index equities (including convertible bonds) and gold		20		
Other equities and convertible bonds listed on a recognised exchange		30		

[24] This includes banks, domestic PSEs and corporates.

[25] Securitisation exposure has the meaning given in APS 120.

[26] Unrated bank securities must meet the requirements set out in paragraph 14(d) of this Attachment.

Securities that are posted collateral but not eligible financial collateral	30
Units in trusts	Highest haircut applicable to any security in which the trust can invest
Cash[27]	0
Securities forming part of posted or received collateral for transactions that satisfy the criteria in paragraphs 19 and 20 of this Attachment, provided that, if the transaction is in a netting set, all transactions in that netting set satisfy those criteria[28]	0

29. An ADI must apply a haircut of 8 per cent for currency risk ($H_{fx,i}$) where the exposure and collateral are denominated in different currencies, and zero per cent where they are denominated in the same currency.

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

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

Table 24 Minimum holding periods and conditions

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

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

    (a) for all netting sets where the number of trades exceeds 5,000 at any point during a quarter, an ADI must set the minimum holding period to 20 business days for the following quarter;

---

27 For received collateral, only amounts that satisfy the eligible cash collateral requirements set out in paragraph 14(a) of this Attachment may be recognised as cash for this purpose.

28 For the avoidance of doubt, if a netting set includes any transaction that does not meet the criteria in paragraphs 19 and 20 of this Attachment, no transactions in the netting set are eligible for the zero per cent haircut.

(b) for netting sets containing one or more trades involving either illiquid collateral, or an OTC derivative that cannot be easily replaced, an ADI must set the minimum holding period to 20 business days. An ADI must determine both liquidity and ease of replacement in the context of stressed market conditions; and

(c) if an ADI has experienced more than two margin call disputes on a particular netting set over the previous two quarters that have lasted longer than the applicable minimum holding period (before consideration of this provision), the ADI must use a minimum holding period that is at least double the supervisory floor for that netting set for the subsequent two quarters.

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

32. An ADI must calculate the margining frequency adjustment factor for a transaction or netting set as:

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

where:

T_M is the minimum holding period for the type of transaction determined in accordance with paragraphs 30 to 31 of this Attachment

N_R is the number of business days between remarginings or revaluations.

Treatment of SFTs covered by master netting agreements

33. For SFTs covered by an eligible bilateral netting agreement that meets the requirements detailed in Attachment H to this Prudential Standard, an ADI that uses the comprehensive approach must calculate the EAD as:

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

where:

E^* is the adjusted EAD of the netting set

E_i is the current value of all cash lent and non-cash posted collateral

C_j is the current value of all cash borrowed and non-cash received collateral

$$net\ exposure = \left|\sum_{S} E_s H_s\right|$$

$$gross\ exposure = \sum_{S} E_s |H_s|$$

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

H_s is the haircut appropriate to E_s, as set out in Table 23 and scaled by the margining frequency adjustment factor in paragraph 32 of this Attachment. H_s has a positive (negative) sign if the security is posted (received) collateral

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

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

H_{fx} is the haircut appropriate for currency mismatch of currency *fx*.

Attachment H – Netting

1. An ADI may reduce its exposure amount, for the purpose of calculating its Regulatory Capital requirement, through the application of close-out netting or netting by novation, in accordance with the requirements set out in this Attachment.

2. An ADI that chooses to net transactions must do so on a consistent basis, and must apply netting to all transactions in both the banking book and trading book that are covered by a netting agreement.

3. An ADI that applies netting for Regulatory Capital purposes must have a netting policy that, at a minimum, addresses the requirements in this Prudential Standard. The netting policy must apply to all transactions subject to netting and include systems and controls for:

   (a) monitoring and reporting netted transactions on a gross and net basis; and

   (b) monitoring and managing roll-off risk and termination risk.

4. An ADI must maintain adequate records to support the application of the netting agreement.

Use of netting

5. For Regulatory Capital purposes, an ADI may only net the following types of transactions:

   (a) on-balance sheet loans and deposits;

   (b) SFTs; and

   (c) OTC derivative transactions (across both the banking and trading books) with a single counterparty. This may include netting across different types of derivatives, but not across derivatives and SFTs.

6. An ADI may only net internal transactions between the banking book and trading book if:

   (a) the netted transactions are marked-to-market daily, where applicable;[29] and

   (b) any collateralised instruments used in the transactions comply with the criteria for eligible collateral in the banking book as detailed in Attachment G to this Prudential Standard.

[29] The holding period for the haircuts depends, as for other SFTs, on the frequency of margining.

On-balance sheet netting

7. An ADI may only use the net exposures of loans and deposits as the basis for its RWA calculation where it:

   (a) has a well-founded basis for concluding that the netting or offsetting agreement is legally enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt;

   (b) is able at any time to determine those loans and deposits with the same counterparty that are subject to the netting agreement, and the deposits meet the criteria for eligible financial collateral;

   (c) monitors and controls its roll-off risks; and

   (d) monitors and controls the exposures on a net basis.

8. Where all of the conditions in paragraph 7 of this Attachment are satisfied, an ADI may net loans and deposits to calculate RWA by applying the relevant requirements under either the simple or comprehensive approach as set out in Attachment G to this Prudential Standard. For this purpose, loans must be treated as exposures and deposits must be treated as eligible financial collateral.

Eligible bilateral netting agreement

9. An eligible bilateral netting agreement, which includes a master netting agreement, is a netting agreement with a counterparty which:

   (a) provides the non-defaulting party the right to terminate and close out, in a timely manner, all transactions under the netting agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;[30]

   (b) provides for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it, so that only a single net amount is owed by one party to the other;[31]

   (c) allows for the prompt liquidation or set-off of collateral upon the event of default;

   (d) is legally enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt; and

---

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

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

(e) does not include a walkaway clause (i.e. any clause which, in the event of default of a counterparty, permits a non-defaulting counterparty to make limited payments only, or no payments at all, to a defaulting party, even if the defaulting party is a net creditor).

Legal enforceability

10. To ensure the legal enforceability of a netting agreement, an ADI must:

(a) obtain a written and reasoned legal opinion that concludes that in the event of default, liquidation, bankruptcy or other similar circumstances of a party to the netting agreement, the relevant courts and authorities would find the ADI's exposure is limited to the single net sum determined in the netting agreement under:

(i) the law of the jurisdiction in which the counterparty is incorporated, formed or resides (in the case of a natural person), and if a foreign branch of the counterparty is involved, the law of the jurisdiction in which the branch is located;

(ii) the law that governs the individual transactions involved; and

(iii) the law that governs any contract or agreement necessary to give effect to the netting; and

(b) have policies and procedures in place to ensure that the legal enforceability of netting agreements is kept under review in response to possible changes in relevant laws.

11. An ADI must not recognise a netting agreement for Regulatory Capital purposes if there is any doubt as to its legal enforceability. Where an ADI becomes aware that a regulator or supervisor of a counterparty has given notice that it is not satisfied that netting is enforceable under the laws of the regulator's or supervisor's home country, it must not recognise the netting agreement for Regulatory Capital purposes regardless of any legal opinion obtained by the ADI.

Attachment I – Guarantees

1. Where an ADI's exposure to a counterparty is covered by a guarantee from an eligible guarantor, an ADI may substitute the risk weight of the counterparty for the risk weight of the guarantor for the covered portion of the exposure.[32] The uncovered portion of the exposure must be risk-weighted according to the risk weight applicable to the original counterparty.

Minimum requirements

2. To be recognised as eligible CRM, a guarantee must:

   (a) represent a direct claim on an eligible guarantor;

   (b) be an explicitly documented obligation assumed by the guarantor;

   (c) be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible;

   (d) be irrevocable, except in the case of non-payment by a protection purchaser of money due in respect of the credit protection contract. The guarantee must not contain any clauses that would allow the guarantor to unilaterally cancel the cover of the guarantee, or that would increase the effective cost of cover as a result of deteriorating credit quality in the guaranteed exposure;[33]

   (e) be unconditional. The guarantee must not include any clauses that are outside the direct control of the ADI, or that could prevent the guarantor from being obliged to pay out in a timely manner in the event that the underlying counterparty fails to make the payment(s) due;

   (f) on the default or non-payment of the counterparty, allow the ADI to pursue, in a timely manner, the guarantor for any monies outstanding under the documentation governing the transaction. The ADI must have the right to receive payment from the guarantor without first having to take legal action in order to pursue the counterparty for payment; and

   (g) cover all types of payments the underlying borrower is expected to make under the documentation governing the transaction. Where a guarantee covers payment of principal only, interest and other amounts not covered by the guarantee must be treated as uncovered.

---

[32] Guarantees that provide partial coverage whereby the ADI and guarantor share losses on a *pro rata* basis are eligible for the same recognition.

[33] While the requirement for irrevocability does not require that the guarantee and the exposure be maturity matched, the guarantor must not have the ability to change the agreed maturity *ex post*.

Eligible guarantors

3. An ADI must only recognise guarantees provided by the following entities when they have a lower risk weight than the counterparty:

   (a) sovereigns;

   (b) banks;

   (c) other entities that are externally rated, where credit protection is provided to a non-securitisation exposure. This includes guarantees provided by parent, subsidiary and affiliate companies where they have a lower risk weight than the borrower; and

   (d) where credit protection is provided to a securitisation exposure, other entities with a credit rating grade of three or better and that were externally rated two or better at the time the credit protection was provided. This also includes guarantees provided by parent, subsidiary and affiliated companies where they have a lower risk weight than the borrower.

4. A claim that is indirectly guaranteed by the Australian Government (i.e. the Commonwealth's guarantee of the entity that provides the guarantee) may be treated as guaranteed by the Australian Government provided that:

   (a) the indirect guarantee covers all credit risk elements of the claim;

   (b) both the original guarantee and the indirect guarantee meet all the requirements detailed in paragraph 2 of this Attachment, except that the indirect guarantee need not be direct and explicit to the original claim; and

   (c) the ADI is satisfied that the cover of the indirect guarantee is robust and there is no historical evidence to suggest that the coverage of the indirect guarantee is not equivalent to that of a direct guarantee of the Australian Government.

5. Letters of comfort do not qualify as eligible guarantees for CRM purposes.

Materiality thresholds

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

Proportional and tranched cover

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

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

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

Currency mismatch

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

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

where:

G = nominal amount of the guarantee

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

10. Where there is a currency mismatch, an ADI must apply a haircut of 8 per cent (based on a 10 business day holding period and daily marking-to-market). The haircut must be adjusted depending on the actual frequency of revaluation of the currency mismatch, in accordance with paragraph 32 of Attachment G to this Prudential Standard.

Maturity mismatch

11. A maturity mismatch exists where the residual maturity of a guarantee is less than the maturity of the exposure covered by the guarantee.

12. Where there is a maturity mismatch, a guarantee may only be recognised as eligible CRM where the original maturity of the guarantee is greater than or equal to 12 months and the residual maturity is greater than or equal to 3 months.

13. Where credit protection provided by a single guarantor to the same underlying exposure has different maturities, an ADI must divide the exposure into separate covered portions for risk-weighting purposes.

14. For the purposes of determining maturity:

(a) the effective maturity of the underlying exposure must be calculated using the longest possible remaining time before the counterparty is scheduled to fulfil its obligation; and

(b) for the guarantee, an ADI must take into account any clause or incentive within the documentation supporting the transaction that may reduce its maturity so that the shortest possible effective maturity is used.

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

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

where:

P_a	=	value of the guarantee adjusted for maturity mismatch
P	=	guarantee amount adjusted for any haircuts (in which case, $P = G_a$ as determined in paragraph 9 of this Attachment)
t	=	min (T, residual maturity of the guarantee) expressed in years
T	=	min (5, residual maturity of the exposure) expressed in years.

Attachment J – Credit derivatives

Purchased credit protection

1. Where an ADI purchases credit protection through an eligible credit derivative, it may substitute the risk weight of the counterparty with the risk weight of the credit protection seller for the covered portion of the exposure.[34] The uncovered portion of the exposure must be risk-weighted according to the risk weight applicable to the original counterparty.

2. For the purposes of CRM, eligible credit derivatives are limited to:

   (a) single-name credit-default swaps; and

   (b) certain total-rate-of-return swaps.

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

3. Cash-funded credit linked notes issued by an ADI against exposures in the banking book that satisfy the minimum requirements for credit derivatives as detailed in this Attachment (with the exception of eligible credit protection providers set out in paragraph 12 of this Attachment) may be treated as cash-collateralised transactions under Attachment G to this Prudential Standard.

4. Where an ADI buys credit protection through a credit derivative that forms part of a synthetic securitisation, the requirements detailed in APS 120 apply.

Minimum requirements

5. To be recognised as eligible CRM, a credit derivative must:

   (a) represent a direct claim on the protection seller;

   (b) be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible;

   (c) be irrevocable, except in the case of non-payment by a protection purchaser of money due in respect of the credit protection contract. The credit derivative contract must not include any clause that would allow the protection seller to unilaterally cancel the protection of the credit derivative,

[34] Credit derivatives that provide partial coverage whereby the ADI and the credit protection seller share losses on a *pro rata* basis are eligible for the same recognition.

or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure;[35]

(d) be unconditional. The credit derivative contract must not include any clauses that are outside the direct control of the ADI, and the credit events specified in the contract must not prevent the protection seller from being obliged to pay out in a timely manner in the event that the borrower of the underlying exposure fails to make the due payment(s);

(e) at a minimum, specify the following as credit events under the terms of the credit derivative contract:

(i) the failure to pay an amount due under the terms of the underlying exposure that is in effect at the time of such failure;

(ii) the bankruptcy, insolvency or inability of the borrower of the underlying exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as those debts become due, or analogous events; and

(iii) subject to paragraph 9 of this Attachment, the restructuring of the underlying exposure, including any forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. write-off, provision for a defaulted exposure or other similar debit to the profit and loss account of the ADI);

(f) not terminate prior to the expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay; and

(g) clearly identify those parties responsible for determining whether a credit event has occurred. This determination must not be the sole right of the protection seller. An ADI buying the credit protection must have the right and ability to inform the protection seller of the occurrence of a credit event.

6. Where the credit derivative is based on cash settlement, the ADI must have a robust valuation process in order to reliably estimate losses on the reference obligation specified in the credit derivative contract, including a defined period for obtaining post credit event valuations of the reference obligation.

7. Where an ADI purchases credit protection and an existing credit exposure of the ADI is the deliverable obligation under the credit derivative contract, the terms of the underlying exposure must allow for its transfer to the protection seller. If the protection purchaser's right and ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying

[35] While the requirement for irrevocability does not require that the credit derivative and the exposure be maturity matched, the credit protection provider must not have the ability to change the agreed maturity *ex post*.

obligation must provide that any required consent to such transfer may not be unreasonably withheld.

8. An exception to paragraph 7 of this Attachment applies where there is a restriction on the transfer of the existing credit exposure and this restriction only applies in the event of restructuring. In this case, the limit described in paragraph 9 of this Attachment applies as if restructuring of the underlying exposure was not included within the terms of the credit derivatives contract.

9. If restructuring of the underlying exposure is not included within the terms of the credit derivative contract but all other requirements of paragraphs 5 to 7 of this Attachment are met, an ADI may recognise 60 per cent of the lesser of the amount of the credit protection purchased and the amount of the underlying exposure.

10. Where there is a mismatch between the underlying obligation and the reference obligation under the credit derivative, including the obligation used for the purposes of determining the cash settlement value or the deliverable obligation, an ADI may only recognise the credit derivative as eligible CRM if the following conditions are satisfied:

    (a) the reference obligation ranks *pari passu* with, or is junior to the underlying obligation; and

    (b) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.

11. Where there is a mismatch between the underlying obligation and the obligation used for the purposes of determining whether a credit event has occurred, an ADI may only recognise the credit derivative as eligible CRM if the following conditions are satisfied:

    (a) the obligation used to determine whether a credit event has occurred ranks *pari passu* with, or is junior to, the underlying obligation; and

    (b) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.

Eligible credit protection providers

12. An ADI must only recognise credit protection provided by the following entities:

    (a) sovereigns;

    (b) banks;

    (c) other entities that are externally rated, where credit protection is provided to a non-securitisation exposure. This includes credit protection provided by parent, subsidiary and affiliate companies where they have a lower risk weight than the borrower; and

(d) where credit protection is provided to a securitisation exposure, other entities with a credit rating grade of three or better and that were externally rated two or better at the time the credit protection was provided. This also includes credit protection provided by parent, subsidiary and affiliated companies where they have a lower risk weight than the borrower.

Materiality thresholds

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

Proportional and tranched cover

14. Where there is partial coverage of an underlying exposure by a credit derivative and the protected and unprotected portions are of equal seniority (i.e. the ADI buying credit protection and the protection seller share losses on a *pro rata* basis), capital relief will be afforded on a proportional basis. This means that the protected portion of the underlying exposure will receive the capital treatment applicable to eligible credit derivatives with the remainder treated as unprotected.

15. Where there is partial coverage of an underlying exposure by a credit derivative and there is a difference in seniority between the protected and unprotected portions of the underlying exposure, then the arrangement is considered to be a synthetic securitisation and is subject to the requirements set out in APS 120.

Currency mismatch

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

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

where:

G = nominal amount of the credit derivative

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

17. Where there is a currency mismatch, an ADI must apply a haircut of 8 per cent (based on a 10 business day holding period and daily marking-to-market). The haircut must be adjusted depending on the actual frequency of revaluation of the currency mismatch, in accordance with paragraph 32 of Attachment G to this Prudential Standard.

Maturity mismatch

18. A maturity mismatch exists where the residual maturity of a credit derivative is less than the maturity of the underlying exposure.

19. Where there is a maturity mismatch, a credit derivative may only be recognised as eligible CRM where the original maturity of the credit derivative is greater than or equal to 12 months and the residual maturity is greater than or equal to 3 months.

20. Where credit protection provided by a single protection seller to the same underlying exposure has different maturities, an ADI must divide the exposure into separate covered portions for risk-weighting purposes.

21. For the purpose of determining maturity:

    (a) the effective maturity of the underlying exposure must be calculated using the longest possible remaining time before the counterparty is scheduled to fulfil its obligation; and

    (b) for the credit derivative, an ADI that purchases credit protection must take into account any clause or incentive within the credit derivative contract that may reduce its maturity so that the shortest possible effective maturity is used.

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

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

where:

P_a	=	value of the amount of credit protection adjusted for maturity mismatch
P	=	the amount of credit protection adjusted for any haircuts (in which case, $P = G_a$ as determined in paragraph 16 of this Attachment)
t	=	min (T, residual maturity of the credit derivative) expressed in years
T	=	min (5, residual maturity of the underlying exposure) expressed in years.

Sold credit protection

23. An ADI that sells credit protection that is not detailed in paragraphs 29 and 30 of this Attachment must, prior to execution of the relevant credit derivative contract, undertake a written assessment of the appropriate Regulatory Capital treatment for the transaction. The ADI must notify APRA prior to execution and provide its written assessment to APRA upon request. The ADI must apply the treatment set

out in its written assessment unless APRA determines an alternative methodology for calculating the Regulatory Capital treatment.

24. Where an ADI uses total-rate-of-return swaps to hedge a banking book credit exposure in accordance with the requirements set out in this Attachment, those transactions must be included in the ADI's banking book. All other total-rate-of-return swaps must be included in an ADI's trading book.

25. Any instruments that would give rise to a net short credit or equity position in the banking book must be included in an ADI's trading book.[36]

26. An ADI that has sold credit protection using a credit derivative must, for capital adequacy purposes, assume that 100 per cent of the credit risk is purchased irrespective of the range of specified credit events.

27. An ADI that sells credit protection using a credit derivative containing an embedded option to extend the term of the credit derivative must assume the longest possible effective maturity of the credit derivative. This is regardless of any contractual arrangements that may give either the protection buyer or the protection seller the incentive to reduce the contract term.

28. When determining the amount of credit protection sold, an ADI must assume that any materiality thresholds included in the credit derivative contract do not reduce the acquired credit risk.

Credit-default swaps

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

First- and second-to-default basket credit derivatives

30. An ADI which sells credit protection through a first-to-default or second-to-default credit derivative, must apply the following capital requirements to these exposures:

    (a) for first-to-default credit derivatives, the risk weights of the assets included in the basket must be aggregated up to a maximum of 1250 per cent and multiplied by the nominal amount of the protection provided by the credit derivative to obtain the risk-weighted asset amount; and

    (b) for second-to-default credit derivatives, the treatment is similar; however, in aggregating the risk weights, the asset with the lowest risk-weighted

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

amount can be excluded from the calculation. This treatment applies respectively for *n*th-to-default credit derivatives, for which the *n*-assets with the lowest risk-weighted amounts can be excluded from the calculation.