



19 March 2020

Ms Katrina Squires
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Dear Ms Squires

APG 220 Credit Risk Management Consultation

The Australian Banking Association (**ABA**) welcomes the opportunity to make this submission on the draft Prudential Practice Guide APG 220 Credit Risk Management (APG 220).

Key issues and recommendations

The ABA appreciates the timely review of APG 220 to complement the new prudential standard. The presence of a well-functioning credit risk management system is fundamental to the safety and soundness of any authorised deposit-taking institution (ADI). In general, the ABA is supportive of APRA's proposal to modernise the prudential guidance in line with contemporary credit risk management practices.

However, it is important to ensure that APG 220 sits comfortably within a predictable and transparent regulatory framework for ADIs. Key definitions and concepts should be clear and consistent with existing requirements, including those set by other agencies such as ASIC. In addition, the Prudential Practice Guide should not endeavour to go beyond the requirements established in its accompanying Prudential Standard APS 220.

The ABA has provided specific examples and recommendations where we consider that regulatory consistency and clarity could be improved within APG 220. These recommendations are grouped under the same titles as those used in the draft APG 220, for ease of reference.

In addition, the ABA requests that APRA defer the implementation date of 1 January 2021 for APS 220 by 12 months. This request is made given the expected and potential impact of COVID-19 on the Australian community. Delaying APS 220 would allow credit risk subject matter experts within each ADI to focus more effectively and efficiently on credit risk assessment and monitoring as it is needed.

Yours sincerely

Jess Boddington
Policy Director

About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers.

We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.



Role of the Board and senior management

The revised APS 220 clarifies APRA's expectations of the role of the Board of an ADI. In APG 220, these expectations are expanded on with guidance for how the APS 220 should be interpreted. The ABA has one general comment and two specific comments on this expanded guidance.

General comment

The ABA requests that APRA add a clarification into APG 220 to make clear that the standard of evidence kept by the Board should be reasonable and proportionate to the issue being raised. This is analogous to the clarification contained in Paragraph 40 of APS 220 regarding the standard to be used in credit risk assessments.

Paragraphs 16 and 18

The ABA's concern regarding paragraphs 16 and 18 are similar: the language used in the guidance goes beyond the requirements set by the prudential standards. The risk here is that the guidance sets an unnecessarily high standard of evidence compared to the proportionality of the inherent risk at stake.

Paragraph 16 of APG 220 calls for the Board to '*sufficiently, actively and rigorously engage*' on credit risk issues. The ABA considers that this expectation goes beyond the APS 220 requirement for the Board to '*regularly challenge, seek assurance and evidence*' on similar topics contained in APS 220. The ABA would recommend replacing the words '*sufficiently, actively and rigorously engage*' in paragraph 16 to '*regularly challenges, seeks assurance and evidence on credit risk issues.*'

Paragraph 18 also introduces a new concept not contained in the APS 220, whereby the Board is expected to be alert to '*credit deterioration and signs that there may be problems that senior management may not be raising with the Board.*' The ABA recommends that this sentence is deleted.

Credit origination and assessment and approval

APG 220 includes revised guidance for how to manage risks associated with credit origination, assessment and approval. The ABA has a general comment on this expanded guidance.

General comment

One of the most important principles in the new APS 220 is contained in paragraph 40 which allows ADIs to adopt a scalable and flexible approach to credit risk assessment, considering the nature, type and size of the exposure. This approach is sound, enabling ADIs to focus more resources where they are needed, and is also included in paragraphs 42 and 44 of APG 220.

The requirement in paragraph 40 of APS 220 recognises the various approaches to credit assessment adopted by ADIs, commensurate with the nature, size and complexity of a transaction. These approaches may not necessarily involve analysis by a credit analyst on all transactions but do involve experienced credit judgement. For example, they may involve automated decisioning solutions (where credit judgement is used in the development and review of scorecards and policy rules) or individual delegated credit authority provided to an experienced banker.

However, paragraph 66 of APG 220 states, '*APRA expects that each credit proposal would be subject to careful analysis by a qualified credit analyst with expertise commensurate with the nature, size and complexity of the transaction.*' The ABA therefore recommends that the first sentence in paragraph 66 is removed.

In addition, the ABA considers several paragraphs in APG 220 describe more traditional techniques to assessing credit risk in non-retail asset class customers and will not always be relevant. For example:

- Paragraph 53 assumes the use of financial analysis to derive financial ratios to monitor the customer's ongoing health.
- Paragraph 64 assumes the credit decision will be judgemental and not automated.



- Paragraph 73 assumes that each customer will have an individual credit file.

Therefore, the ABA recommends removing the above assumptions when finalising APG 220.

Paragraph 68 allows ADIs to use automatic decision engines but implies this will be 'from time to time' rather than regular practice. Automated approaches are the norm for most retail customers. Increasingly, ADIs are seeking to adopt these techniques to small-medium enterprise lending rules as they are fit-for-purpose, reliable and relatively simple.

The ABA recommends that the first sentence in paragraph 68 be replaced with:

'ADIs may utilise an automatic decision engine to decision credit applications.'

Non-performing exposures

APG 220 includes revised guidance as to how to classify and assess non-performing exposures. The ABA has a specific comment on the definition of 'days past due' in this guidance.

Definition: days past due

The ABA is concerned that the APS 220 and APS 113 treatment of 'days past due' are inconsistent and need to be aligned. The new APS 220 concept of non-performing exposures essentially maps to the APS 113 concept of default. However, it does not incorporate the allowance for a small materiality threshold under APS 113 Attachment A, paragraph 79.

The ABA recommends that the Non-Performing Exposures section in APG 220 be amended to include the same allowance for materiality as contained in the current APS 113 Attachment A, paragraph 79. Specifically, the ABA requests insertion of the reference *'though this does not preclude the possibility of materiality considerations entering into the estimation process.'* It is important that the text of the amendment should not refer to APS 113, as this would not cover standardised ADIs.

The allowance is important as it avoids overestimating probability of default estimates and distorting loss given default estimates. Under APS 113, an exposure below this materiality threshold is not treated by an ADI as a default. Therefore, the exposure would not be downgraded and reported as a default.

There is no corresponding materiality allowance in the new APS 220 definition of non-performing in paragraph 12(a). Therefore, there will be a disconnect between what would be reported as a default under APS 113 and as default under APS 220. The ABA believes this may be an oversight, as paragraph 117 of APG 220 refers to a materiality threshold but does not explain it.

Appendix 1 – Recommendations for minor wording changes

Item	Category	Recommendation
1	Credit risk management framework - Role of the Board and Senior Management	<p>The ABA recommends deleting the final sentence in paragraph 17: <i>'The achievement of 'above system' rates of growth is a commonly used metric of 'success' in this area but it is a metric that may have no regard to the quality of lending being written.'</i></p> <p>There are many reasons that can drive above system growth outside of credit risk, including (but not limited to) superior processes, IT investments and customer experience. An 'above system' growth metric is not necessarily a risk indicator regarding the quality of lending being written. Our concern is that this sentence may be misleading and is not needed.</p>
2	Credit assessment and approval - Exposures to individuals	<p>The statement in paragraph 45 <i>'such as looking at a borrower's regular savings pattern to see if it is greater than the contractual repayments under the exposure'</i> could benefit from a more flexible approach. The ABA recommends its replacement with <i>'to satisfy itself (the ADI) of a customer's ability to repay the facility.'</i></p>
3	Credit assessment and approval - Exposures other than to individuals	<p>The ABA recommends APRA delete the following sentence in paragraph 53:</p> <p><i>'In general, proposals reflective of negative interest cover are not serviceable on contracted terms and are inherently dependent upon restructure at some later date.'</i></p> <p>It is not true that all proposals reflective of negative interest cover need to be restructured at a later date. There are some circumstances where interest cover is negative in some years, but the overall servicing assessment indicates an acceptable position. For example, lumpy cash flows for developers and seasonal income across more than one year for agricultural customers.</p>
4	Credit assessment and approval - Other considerations	<p>On the basis that the establishment of provisions does not form part of the credit assessment and credit decisioning process, the ABA recommends the deletion of the final statement in paragraph 62:</p> <p><i>'The ADI would factor these considerations into credit assessment and approval, as well as into the overall portfolio risk management process.'</i></p>
5	Credit administration, measurement and monitoring - Systems for monitoring the overall composition and quality of the credit portfolio	<p>On the basis that some of these items identified in paragraph 92 may not actually be early warning indicators, the ABA recommends that the paragraph be revised to read:</p> <p><i>'Some early warning indicators to identify emerging credit risks <u>may</u> include, but are not limited to, rapid loan growth, growing concentrations in particular exposures and regular or increasing number of overrides/waivers/exceptions approved against the ADI's own credit risk policies and processes.'</i></p>

Appendix 2 – Specific questions for clarification

Item	Category	Reference	Question
1	Credit risk management framework - Internal limits	Paragraph 31: <i>'The extent of portfolio diversification is important. For example, a portfolio comprising many small loans to unrelated borrowers is generally less risky than a portfolio of large loans. Other diversification benefits may exist across geographical locations and credit products and activities.'</i>	This paragraph may benefit from further expansion. For example, was it the intention of APRA to say that a portfolio of large loans to a single borrower or group of related borrowers is riskier than a portfolio comprising many small loans to unrelated borrowers.
2	Credit risk management framework - Internal limits	Paragraph 36: <i>'It is good practice for ADIs to consider the results of stress testing in the overall limit setting process. Such stress testing would take into consideration economic and credit cycles, interest rate and other market movements, and liquidity conditions.'</i>	The phrase 'liquidity conditions' may benefit from further clarification. For example, is APRA referring to the expected market liquidity at the time for collateral realisation. Similarly, the ABA would welcome clarification on what the phrase 'other market movements' is intended to capture.
3	Credit assessment and approval - Exposures other than to individuals	Paragraph 55: <i>'For asset leasing, an ADI lessor would need to assess not only the creditworthiness of the lessee, but in the case of an operating lease, the residual asset risk associated with the underlying asset.'</i>	This statement may benefit from further expansion. The ABA considers that this statement is only applicable in circumstances where the ADI is taking on the residual risk of the underlying asset. Where the residual risk is outsourced to a third party (e.g. fleet leasing), then the ADI should need only consider this risk upfront as part of the procurement arrangement, with the third party assuming the residual risk if they are a strong enough counterparty and the step-in rights are held by the ADI.
4	Non-performing exposures	There are currently no paragraphs in the APG 220 that provide guidance on the reclassification of non-performing exposures.	The ABA seeks clarity on the reclassification of non-performing exposures to performing in cases where a partial principal write-off is applied as part of a restructure. The wording in the APS 220 could be interpreted as restructured exposures with partial write-off can never be reclassified from non-performing to performing. The ABA believes APRA's intent is that once the partial write-off has been made and restructure applied, then



5 Restructured
exposures

Paragraph 126 of the APG 220 states that *'restructured exposures may be classified as 'performing' or 'non-performing' for regulatory reporting purposes. The appropriate classification will depend on the status of the exposure at the time when a concession is granted and the borrower's payment history or creditworthiness after the extension of the concession.'*

providing the exposure does not meet the definition of non-performing in APS 220, paragraph 12(a) and restructured payments under the revised contractual terms of the restructured exposure have been made in a timely manner over a continuous repayment period of not less than six months (in line with APS 220, paragraphs 94 and 102), then the exposure can be reclassified from non-performing to performing.

For greater clarity, the ABA recommends the addition of examples where it would be appropriate for restructured exposures to be classified as 'performing'.

Appendix 3 – General questions for clarification

Item	Category	Reference	Question
1	External financial disclosures - APS 330	The introduction of the concept of 'non-performing' exposures (paragraphs 113-117), refinements to the classification of restructures (paragraphs 126) and items disclosed in APS 330 (such as 'GRCL' & 'impaired facilities') which are no longer defined by the drafts APS 220 and APG 220 will have implications for external financial disclosures.	Further clarity is required from APRA on disclosure requirements (APS 330) and when this will be updated to reflect the changes to APS 220 and its accompanying APG 220.
2	ARF 220	APRA had confirmed in their response to submissions on the draft APS 220 that it would 'separately consult on revised reporting requirements for credit risk management that would take effect at the same time as the final APS 220 and APG 220.'	The ABA seeks clarification as to the timing of this consultation.
3	APG 220	The implementation date for APS 220 is 1 January 2021.	The ABA seeks clarification as to the timing of when the final guidance is expected to be released, noting that time will be needed for our members to train staff to comply with the new standard.