20 August 2021

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

By email: ADIpolicy@apra.gov.au
cc: Gideon.Holland@apra.gov.au

Dear Mr Holland

Bank Capital Reforms: Update

The Australian Banking Association (**ABA**) welcomes the opportunity to provide a response to the letter on capital framework revisions published by the Australian Prudential Regulation Authority (**APRA**) on 21 July 2021. We thank APRA for its continued engagement with industry on this important reform, including by providing an early indication on key policy settings for the prudential framework.

Our position

The ABA recognises the importance of stability in the Australian financial system and the role that the capital framework plays in this stability. We support a revised capital framework that strengthens the financial resilience of the industry, embeds unquestionably strong levels of capital and also provides for greater flexibility in periods of stress.

In December 2020, APRA released a consultation package on the draft prudential standards that underpin these reforms. The ABA submitted feedback on this consultation package in April 2021. We would like to thank APRA for its update of several policy settings in line with the feedback provided. The observations and recommendations below provide feedback on the revised policy settings, echo unresolved issues raised in our initial submission and introduce additional points for clarification.

Key issues

Implementation

The implementation roadmap set out by APRA in its 2 June letter will be challenging for both the industry and the regulator to adhere to. The revisions to the capital standards are substantive and will require time to complete system and process changes and to undertake assurance exercises to ensure compliance with the new standards. Further operational pressure is added in the current environment where the unpredictable impact of lockdowns makes it difficult to operate business as usual.

In recognition of these challenges, we recommend that APRA:

- replace the parallel run with targeted quantitative impact surveys (**QIS**)
- delay the implementation of the standardised approach for foundation and advanced internal ratings based (**FIRB and AIRB**) authorised deposit-taking institutions (**ADIs**)

- reduce the regulatory reporting burden on ADIs for March 2023, and
- delay the implementation of new Pillar 3 changes to 2024.

Calibration process

APRA has indicated that it has calibrated the framework using both the data from the QIS as well as expectations of home loan outcomes to achieve unquestionably strong outcomes. The ABA would appreciate APRA sharing more details on the calibration process, including capital targets. An early understanding of APRA's approach to calibration and the calibration outcomes will allow ADIs to progress with the work to implement the new standards and to account for its impact on capital planning, forecasting and stress testing.

Capital buffers

The ABA supports the stated policy objective of maintaining unquestionably strong capital levels. However, to maximise flexibility within the revised framework, we strongly recommend that APRA:

- Increase the size of the counter-cyclical capital buffer (**CCyB**) or create a new form of flexible buffer as an alternative to the proposed increase in the capital conservation buffer (**CCB**) for IRB banks.
- Adjust capital conservation ratios such that distribution restrictions would not apply to the first 1 per cent of the proposed 10.5 per cent regulatory minimum.[1]
- Provide further guidance on the useability of regulatory buffers, including the specific criteria by which the CCyB (or other flexible buffers) will be reduced in a stress.
- Provide a framework for other regulatory measures that can be adopted to improve resilience under stress, including the addition of excess of provisions over regulatory expected loss and removing the procyclicality introduced by the AASB 9 framework (which is particularly impactful for Australian ADIs).

Reserve Bank of New Zealand (RBNZ) capital reforms

The ABA considers that the proposed capital allocation to New Zealand exposures at Level 2 is set at a conservative level that is not suitable for an Australian context. We request that APRA remove the floor requirements for credit risk capital from the Level 2 calculations and adopt a 1.05 scalar.

Physical collateral

We acknowledge the concessions that APRA has provided to the FIRB definition through the addition of the new category of exposures. However, the ABA remains concerned that the definition of 'Other eligible physical collateral' continues to lack sufficient flexibility in eligibility criteria. In addition, we consider that the proposed credit treatment for 'Exposures with eligible recovery value' remains too restrictive and that the category should be expanded to include a broader range of other exposures.

Conditions precedent

The ABA accepts APRA's position that exposures with conditions precedent may result in a credit exposure and therefore should be generally treated as commitments. However, we consider that the proposed policy settings need to be further refined to account for transactions with material conditions precedent and self-liquidating trade facilities.

[1] At a minimum, AT1 distribution restrictions should be removed from the first 1 per cent of the proposed regulatory capital buffer (e.g., the CCyB or new flexible buffer). It is preferable however, that the AT1 distributions remain unrestricted until the CET1 ratio breaches the first quartile of the CCB (in which case no AT1 distributions can be paid). This will significantly improve system resilience and confidence, with immaterial impact to prudential safety.

Request for further engagement

We appreciate the clear roadmap for consultation and industry engagement that APRA has provided to date. However, the ABA requests an additional workshop with APRA to discuss the proposed policy settings for the following reforms:

- capital buffers
- physical and eligible collateral
- commitments and the application of credit conversion factors (**CCFs**)
- definition of public sector entities (**PSEs**)
- trade finance
- aggregating commercial facilities and revenue thresholds for small to medium enterprise (**SME**) classification, large exposure classification and application of the firm-size adjustment
- subordinated debt, and
- the calculation of predominance for multiple loans with multiple securities.

Further comments on the consultation materials are provided in Appendices A to D of this letter. Please contact me on jess.boddington@ausbanking.org.au or at 0412 646 864 if you have any questions.

Yours sincerely

Jess Boddington

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.

Australian Banking Association

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Appendix A: Implementation and policy development

This appendix outlines our key concerns regarding APRA's approach to developing and implementing the capital revisions framework reforms:

A1. Implementation

A2. Calibration

A1. Implementation

The ABA acknowledges APRA's commitment to implement the UQS framework on 1 January 2023, consistent with the timing set by the Basel Committee on Banking Supervision (**BCBS**).

However, the implementation roadmap set out by APRA in its letter of 2 June 2021 will be challenging for both the industry and the regulator to adhere to. The revisions to the capital standards are substantive and will require time to complete system and process changes and to undertake assurance exercises to ensure compliance with the new standards. Further operational pressure is added in the current environment where the unpredictable impact of lockdowns makes it difficult to operate business as usual.

Recommendation

We recommend that APRA make the following adjustments to its implementation roadmap:

1. **Replace the parallel run with targeted QIS exercises**

The proposed roadmap indicates that a parallel run will commence in quarter 4 of 2022, based on data from the September quarter. The inclusion of a parallel run brings the timelines forward by three to six months, reducing the time allowed for ADIs to safely implement the framework. Replacing a full parallel run with targeted QISs will still allow APRA to access data on the impact of the Basel III framework, without the burden required to operationalise capital and reporting requirements before the implementation date.

2. **Delay the implementation of the standardised approach for FIRB and AIRB ADIs**

The implementation of the standardised approach is a new requirement for foundation and advanced internal ratings based ADIs. We recommend that APRA allow best endeavours reporting of the standardised floor for a period of 12 months, with full implementation by 1 January 2024 to align with the strategic reporting requirements.

It is noted that APRA does not expect the capital floor to be binding, and so a deferral of the implementation of the standardised capital floor should not undermine APRA's central objectives of financial resilience and stability. A deferral would provide IRB ADIs with additional time to implement the required changes to calculate capital and report on a standardised basis, whilst still meeting the 1 Jan 2023 deadline for implementation of the IRB changes aimed at improving banking resilience.

3. **Reduce the regulatory reporting burden on ADIs for March 2023**:

In APRA's proposed reporting schedule, ADIs will be required to implement 'interim' reporting changes by March 2023 which will be replaced by strategic reporting in mid-2024. This is similar to the model being adopted for the changes to ARS 220.0 Credit Exposures and Provisions (**ARS 220**).

While ADIs appreciate the delay to the strategic reporting requirements, minimising changes to existing reports to support 'interim reporting standards' would allow more resources to be allocated to implementing the capital standards. This would include not requiring additional APRA Reporting Form (**ARF**) returns to be developed and limiting changes to existing regulatory reports.

4. **Delay the implementation of Pillar 3 changes to 2024**:

APRA has not yet released the draft Pillar 3 standards or timelines. If APRA choose to adopt the Basel III Pillar 3 standards, the changes to public disclosures will be substantial. Delaying the implementation

of Pillar 3 changes to 2024 will align this to the APRA reporting timelines and allow more time for ADIs to focus on implementation of the capital framework.

A2. Calibration

APRA position

APRA's roadmap to 2023 indicated that the Basel III Framework would be finalised in November 2021, prior to FIRB and AIRB ADIs completing their residential property and interest rate risk in the banking book (**IRRBB**) models.[2] At an ABA/APRA workshop on Thursday 29 July 2021, APRA indicated that it has factored in estimates of the home loan loss given default models (**LGDs**) into its calibration to ensure unquestionably strong targets at an industry level are met.

The ABA would appreciate APRA sharing more details on the calibration process for FIRB and AIRB banks, including how the LGD accreditation process will work and its target calibration settings. An understanding of APRA's approach to calibration will allow ADIs to progress with the work to implement the new standards and understand their effect on capital planning, forecasting and stress testing.

[2] APRA, *ADI capital reforms: Roadmap to 2023*, letter to ADIs, 2 June 2021

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Appendix B: Capital issues

This appendix outlines key policy issues relating to capital, noting the relevant prudential standard is APS 110 Capital Adequacy **(APS 110)**:

B1. Capital buffers

B2. Capital floor

B3. RBNZ capital reforms

B1. Capital buffers

APRA position

In December 2020, APRA consulted on several proposals to update APS 110 to improve the flexibility of the framework and meet the unquestionably strong benchmarks. This included increasing capital buffers above minimum prudential requirements to support the ability of ADIs to absorb losses and continue lending during times of stress.

Specifically, APRA proposed to:

- set a base level for the counter-cyclical capital buffer of 1.0 per cent of risk-weighted assets (**RWA**) for all ADIs, and
- increase the capital conservation buffer from 2.5 to 4.0 per cent of RWA for IRB ADIs. The CCB for ADIs on the standardised approach would remain at 2.5 per cent.

In its July update, APRA outlined its intention to maintain the approach to buffers as set out above.

The ABA's April 2021 submission included a suggestion to make greater use of the CCyB with a corresponding reduction in the CCB. We appreciate that APRA has already considered this feedback as part of the previous consultation. However, in light of recent experience and to respond to APRA's feedback in the July proposals, there are some additional points that we consider are relevant for further consideration.

Lessons learnt during the COVID-19 pandemic

APRA's historic stance on regulatory buffers has been that:

- they should not be used other than in exceptional circumstances, and
- when used, the ADI should return to above the regulatory minimum as quickly as possible[13].

However, in a recent publication by the BCBS[4], empirical evidence showed that jurisdictions that reduced their 'flexible' capital buffers (such as the CCyB) were able to better support lending.[5] Other jurisdictions that did not have readily adjustable buffers were constrained in their ability to act counter-cyclically.

Releasing the CCyB is likely to be more effective in providing flexibility to banks during crises in comparison to using the CCB, due to perceived negative implications of dipping into the latter. The BCBS' speech on 20 April 2021[6] noted that ADIs were conscious of:

[3] APG 110, paragraph 38: APRA's expectation is that an ADI would not normally operate in the capital buffer range and that declaring a distribution that takes the ADI into the range would be an exception. If an ADI is within the capital buffer range, APRA would expect the ADI to take timely action to restore its capital position and move out of the capital buffer range as quickly as possible.
[4] BCBS, 'Early Lessons from the Covid-19 pandemic on the Basel Reforms,' July 2021
[5] Seven jurisdictions fully or partially released their CCyB, whilst Brazil, Canada, the ECB, India, Indonesia, the Netherlands, South Africa and the United Kingdom were able to make other changes to ease capital requirements and buffers.
[6] BIS, 'Evaluating the effectiveness of Basel III during Covid-19 and beyond,' speech by Pablo Hernandez de Cos in his Keynote Address at the BCBS-Bundesbank-CEPR workshop on evaluating financial regulation, 20 April 2021.

a) market stigma or negative market signalling which may be perceived as a result of dipping into minimum regulatory requirements[7]

b) potentially breaching automatic distribution limits, which may lead to difficulty in raising new capital if required[8]

c) the potential for reduced profitability through lower credit ratings and higher funding costs[9], as well as

d) if the market or regulators expect buffers to be rebuilt promptly, the costs of doing so may result in banks opting to preserve capital rather than continuing to lend.

Hence, there is a need to enhance regulatory authorities' ability to act counter-cyclically. This **calls for a rebalancing between structural and cyclical elements** of the capital stack e.g., through a higher mix of CCyB or other flexible buffers over the CCB.[10]

Recommendations

Given these observations and the benefits of utilising the CCyB in a crisis rather than the CCB, the ABA considers that APRA could improve the policy framework to improve ADIs' future resilience under stress by:

1. Maintaining the current CCB levels for ADIs (e.g., 3.5 per cent including 1 per cent D-SIB for major banks and 2.5 per cent for non-D-SIB ADIs) and calibrating any potential changes in RWA from these reforms primarily using flexible buffers, such as the CCyB or a new form of flexible buffer.
2. Adjusting capital conservation ratios (per Attachment B of APS 110) such that distribution restrictions would not apply to the first 1 per cent of the proposed 10.5 per cent regulatory minimum.[11]
3. Providing further guidance on the useability of regulatory buffers, in particular the specific criteria by which the CCyB will be reduced in a stress.
4. Providing a framework for other regulatory measures that can be adopted to improve resilience under stress including the addition of excess of provisions over regulatory expected loss and removing the procyclicality introduced by the AASB 9 framework (which is particularly impactful for Australian ADIs).

These recommendations are articulated further below. The ABA would appreciate the opportunity to discuss our proposals in further depth with APRA before the policy settings are finalised.

1. Increasing the flexible buffer

The ABA recommends that APRA increase the size of the flexible buffer component with a corresponding offset to the CCB for IRB banks. This could be achieved either through the CCyB or an alternative form of flexible buffer.

We note that, in the July proposals, APRA signalled an intention to avoid having a different CCyB for IRB banks and standardised banks. It is the ABA's view is that a higher CCyB for IRB banks is warranted given the IRB framework is more cyclical in nature than the standardised framework (e.g., due to the impact of shortfall in provisions and the nature of the value at risk calculation). Given the

[7] BCBS, Author: Drehman et al., 'Buffering Covid-19 Losses - The Role of Prudential Policy,' 24 April 2020.
[8] RBA, Author: Katarina Stojkov, 'Different Approaches to Implementing a Countercyclical Capital Buffer,' September 2020.
[9] Gambacorta & Shin, 'Why bank capital matters for monetary policy,' 2018.
[10] Marco prudential capital buffers – objectives and usability < https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202010_1~01c4f1a5f4.en.html#toc5>
[11] AT1 distribution restrictions should be removed from the first 1 per cent of the capital buffer (e.g., the CCyB or new flexible buffer). It is preferable however, that the AT1 distributions remain unrestricted until the CET1 ratio breaches the first quartile of the CCB (in which case no AT1 distributions can be paid). This will significantly improve system resilience and confidence, with immaterial impact to prudential safety.

greater cyclicality of IRB capital, more flexibility may be needed in the IRB framework than in the standardised framework to provide an effective lever for releasing capital into the economy.

2. Capital distribution constraints

If APRA does not decide to pursue the above recommendation, the ABA submits that, at a minimum, the capital conservation ratios (per Attachment B of APS 110) should be adjusted such that distribution restrictions would not apply to the first 1 per cent of the proposed 10.5 per cent regulatory minimum.

This proposal has the following advantages:

- This amendment can be uniformly applied across advanced and standardised ADIs without changing the nature and composition of proposed regulatory buffers.
- APRA's proposed increases to CCB and CCyB would be more conservative compared the Basel III capital framework. The proposed additional layer without distribution restrictions would not compromise international comparability.
- The proposed adjustment would provide certainty to ADIs when calibrating internal targets in terms of the usability of regulatory buffers in times of stress before more punitive restrictions start applying.
- The reduction in the buffer to the regulatory minimum may also be perceived as constituting a higher risk by AT1 investors and may adversely affect the ability of Australian ADIs to raise this form of capital in a downturn environment. This proposal will preserve the buffer protecting AT1 investors.

To illustrate how this would work in practice, we provide an example in Table 1. While distribution restrictions would not apply to the first 1 per cent of the regulatory minimum (similar to the regime in place for the Canadian Domestic Stability Buffer[12]) a requirement could be put in place requiring a remediation plan to be presented to APRA should an ADI fall into the buffer.

Should a remediation plan not be submitted, existing APRA powers for example increasing an ADI's prudential capital requirement (**PCR**) could be utilised to enforce compliance.

	APRA Current	**APRA Proposed**	**ABA Recommendation**	**Earnings available for distributions**
	>8%	**>10.50%**	**>10.50%**	**100%**
1st 1% of Capital Buffer (CCB+CCyB)	N/A	N/A	>9.50%	100%
4th Quartile	8.000%	10.50%	9.50%	60%
3rd Quartile	7.125%	9.00%	8.25%	40%
2nd Quartile	6.250%	7.50%	7.00%	20%
1st Quartile	5.375%	6.00%	5.75%	0%
PCR	4.500%	4.50%	4.50%	0%

3. Guidance on useability of buffers

Further guidance from APRA on the useability of buffers would provide greater certainty and confidence for ADIs to use them in a stress.

12 In Canada, a Domestic Stability Buffer of 1.5 per cent is applied above the CCB to Domestic Systemically Important Banks (DSIBs), to address systemic vulnerabilities; this buffer acts similarly to the CCyB yet is more targeted in application to only DSIBs and does not result in automatic distribution constraints. A breach of the Domestic Stability Buffer requires a Canadian bank to submit a capital plan to restore capital levels above requirements within a set period of time, with power given to the regulator to intervene in a transparent and expected way if the capital plan is not executed.

Specifically, the ABA recommends that the language in APG 110 paragraph 38 should be adapted to provide certainty in terms of the useability of capital buffers. The guidance at a minimum should include:

- under which circumstances buffers would be useable
- what the supervisory response will likely be in circumstances where buffers are utilised
- the timeframe in which ADIs are required to restore buffers (with the emphasis that any rebuild of capital buffers should be primarily organic in nature and should be conducted in an orderly fashion so as not to affect an ADI's appetite to continue lending during an economic recovery) and
- for the CCyB, the triggers (with reference to macroeconomic data or core industry indicators) that inform when the CCyB should be reviewed and the likely amount it will be changed.

B2. Capital floor

APRA position

APRA has proposed to implement Basel's capital floor that requires total RWAs calculated for an IRB bank to be at least 72.5 per cent of total RWAs calculated under the standardised approaches.[13]

APRA's updated policy settings appear to have resulted in a greater reduction in RWA for IRB ADIs relative to those for standardised banks. All else equal, this could mean a higher likelihood that the capital floor could become the binding constraints for IRB banks, which we understand is not APRA's preference.

Arguably, the calibration of the capital floor at 72.5 per cent by the Basel committee is based on RWA requirements in accordance with the Basel text. As APRA has made significant changes to the Basel minimum requirements (such as the prevalence of super-equivalent capital deductions) there is potential for this super-equivalence to flow through to the calculation of the standardised capital floor.

This super-equivalence could be accounted for by either:

- lowering the calibration of the capital floor to account for this effect, or
- harmonising the RWA for the purposes of testing the capital floor application, i.e., by increasing the level of RWAs under both the IRB and standardised components of the floor calculation to account for deductions that are treated as RWAs under the Basel rules.[14]

Recommendation

The ABA recommends that APRA consider:

- lowering the 72.5 per cent capital floor threshold to account for APRA specific super-equivalent in the capital standards, and/or
- including national-specific capital deductions for equity investments and deferred tax assets above the 10/15 per cent CET1 threshold when assessing Total IRB RWA against the 72.5 per cent capital floor.

B3. RBNZ capital reforms

APRA position

In December 2020, APRA proposed that its IRB requirements would also apply to any exposures of overseas banking subsidiaries that form part of the Level 2 group, with the exception of exposures of

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[13] Noting that for certain assets classes or risk types, there are common approaches for both IRB and standardised ADIs. Draft APS 110, Attachment A, paragraphs 3-4 (December 2020); 'Response to Submissions: A more flexible and resilient capital framework for ADIs', December 2020, page 13.

[14] This would be done by adjusting the capital floor calculation as follows: Capital floor numerator = RWAs under IRB approaches + National-specific deductions/10.5 per cent for D-SIB ADIs or 9.5% for other IRB ADIs (based on APRA's proposed minimum CET1 ratios). Capital floor denominator = RWAs under standardised approaches + National-specific deductions/10.5 per cent for D-SIB ADIs or 9.5 per cent for IRB ADIs. National-specific deductions, per Pillar III disclosures, include for example, DTAs, capitalised expenditures and equity investments.

New Zealand subsidiaries. For these exposures, ADIs would be required to use credit RWAs set by the RBNZ. This approach was intended to simplify capital calculations and remove operational burden.

In its July update, APRA maintained that its current intention is to continue with the proposal to require ADIs to use credit RWAs set by the RBNZ. Further consideration, however, is being given to the merits of the proposal to apply RBNZ's overall IRB scalar and capital floor. APRA will review the results from the QIS at Level 1 and 2 consolidations to determine a final approach.

The ABA maintains that APRA's decision to require ADIs to use credit RWAs set by the RBNZ is unduly conservative. We consider that that, at minimum, APRA will need to ensure the capital buffers at Level 2 are appropriately calibrated such that the inclusion of the above settings do not result in incremental capital requirements over and above the unquestionably strong requirements.

An RWA scalar of 1.2 has been adopted by the RBNZ to meet the objectives of its capital reforms for the New Zealand system.[15] These objectives include:

- limiting the probability of a banking crisis to 0.5 per cent or 1 in every 200 years, and
- materially closing the gap between RWA outcomes for advanced and standardised banks through the combination of a higher scalar for advanced banks and an output floor of 85 per cent for standardised banks.

It is important to understand that the approach adopted by the RBNZ is different to that proposed under the unquestionably strong capital requirements. APRA's proposal balanced achieving a higher level of capital for ADIs, but also considered other aspects of resilience and financial strength in the system. This included improving liquidity and funding profiles, asset quality/mix and lending practices, risk culture, development of credible recovery and resolution plans, and implementation of a requirement for loss-absorbing capacity (**TLAC**)[16].

The difference between the two approaches is evident in the requirements applied to CET1 capital ratios. The RBNZ required a CET1 minimum capital ratio of 13.5 per cent, leading to an overall increase in CET1 capital for ADIs by up to 60 per cent above December 2018 levels. In contrast, APRA targeted an increase of 150 basis points for IRB ADIs, equalling approximately less than 20 per cent above December 2016 levels.

The ABA submits that it is not practical for APRA to adopt the RBNZ's RWA scalar and higher standardised floor for the same reason that it has not adopted its minimum capital ratios. This is because the stated objectives of the reforms reflect the different risk appetites of the regulators.

Recommendation

The ABA considers that:

- the application of the 1.2 scalar should be removed from the credit RWA requirements and replaced with a 1.05 scalar, and
- the RWA floor should be aligned to 72.5 per cent in line with Basel requirements.

[15] The RBNZ also required a CET1 and Tier 1 minimum capital of 13.5% and 16% respectively, leading to an overall increase in CET1 capital by up to 60 per cent of the December 2018 levels.
[16] APRA Information Paper: Strengthening banking system resilience – establishing unquestionably strong capital ratios (July 2017) < https://www.apra.gov.au/sites/default/files/Unquestionably%2520Strong%2520Information%2520Paper_0.pdf>

Appendix C: Credit issues

This appendix outlines key policy issues relating to credit, noting the relevant prudential standards are APS 112 Capital Adequacy: Standardised Approach to Credit Risk (**APS 112**) and Capital Adequacy: Internal Ratings-based Approach to Credit Risk (**APS 113**):

C1. Physical collateral

C2. Conditions precedent

C3. IRB RWA scaling factor

C4. Trade finance

C5. Subordinated debt

C6. External ratings

C7. Commercial property

C8. Public sector entities

C9. Predominance test for exposure with multiple securities and loans

C10. Second mortgages

C1. Physical collateral

APRA position

In December 2020, APRA proposed a definition for a category of exposures to be treated as 'Other eligible physical collateral' under FIRB. To be eligible for this category, the criteria included that there are liquid markets and publicly available market prices for the physical collateral.

In its July update letter, APRA signalled its intention to add a new category, 'Exposures with eligible recovery value', on the basis that there is some physical collateral with recovery value that should be recognised. It outlined that this category would be subject to a supervisory LGD of 40 to 45 per cent and include exposures secured by physical collateral that do not meet the criteria in the draft standard (i.e., APS 113 Attachment E, paragraph 7). It would also include Australian water entitlements and senior exposures to operators of large public infrastructure or utilities that provide essential services to the economy.

Other eligible physical collateral

We acknowledge the concessions that APRA has provided to the FIRB definition through the addition of the new category of exposures. However, the ABA remains concerned that the definition of 'Other eligible physical collateral' continues to lack sufficient flexibility in eligibility criteria.

Liquid markets and publicly available market prices

The qualifying criteria of 'liquid markets' and 'publicly available market prices' generally relate to valuation of commodities traded in financial markets. However, secured loans and leases can be supported by valuable physical collateral that are not traded in financial markets, including:

- aircraft, ships, and container boxes
- manufacturing and production assets
- rail transportation, including light rail, freight and passenger rolling stock
- road transportation, including toll roads and buses
- telecommunications assets
- medical equipment

- mining assets, such as off-highway trucks or excavators
- airports and services to air transportation
- ports and associated assets
- water supply assets, including desalination plants, and
- electricity generation, distribution or transmission assets.

Many of the above asset-types will retain strong value in a default scenario. We are concerned that such collateral may not be recognised if a narrow interpretation of the criteria outlined above is applied. This may result in an unnecessary restriction of credit to certain areas of the economy that have strong fundamentals.

Recommendation

APRA should allow for a broad interpretation of the terms, 'liquid markets' and 'publicly available market prices' when assessing whether an exposure falls within the category of 'Other eligible physical collateral'. In particular, the terminology:

- 'Liquid markets' should consider the physical attributes of the asset. For example, it should be reasonably expected that multiple independent parties would be interested in acquiring the asset and selling costs should not be so large as to result in secondary market sales being uneconomic.
- 'Publicly available market prices' should provide scope for ADIs to utilise recent sales of comparable assets, valuations sourced from independent appraisers and valuations publicly available for purchase.

Physical inspections

The ABA also brings attention to the "physical inspection" requirement. We assume that this criterion was inserted due to a concern around the level of maintenance of the asset to support valuation. On this basis, we note the following:

- Under asset finance arrangements in this segment, the customer is contractually obliged and economically incentivised to maintain the equipment in good working order.
- Some industries are subject to strict regulation such that utilisation itself is clear evidence the asset is appropriately maintained (e.g., passenger aircraft).
- Assets operated under government contract have strict and visible maintenance standards.
- Workplaces such as the mining industry have rigorous health and safety requirements; the ability of non-mining staff to enter mine sites is often not appropriate or permitted.
- Other environments such as data centres are high security, dust-free environments where access is completely restricted, so inspections of assets is extremely unlikely.

Recommendation

The ABA requests that the provision around 'physical inspection' is replaced with the following:

- The ADI retains the documented right (but not obligation) to physical inspection. This would include the ability to outsource the inspection to specialists.
- The ADI has policies and procedures that:
    - trigger a requirement to consider whether the right for physical inspection at the point of customer financial deterioration (this is when maintenance may be compromised) will be exercised, and
    - require customers to provide asset utilisation and reporting information for physical collateral on a regular basis, as appropriate to that collateral type.

Exposures with eligible recovery value

The ABA is grateful for the guidance that APRA has provided as to what exposures may be eligible for the new category, such as exposures secured by physical collateral that do not meet the eligibility criteria, Australian water entitlements and senior exposures to operators of large public infrastructure or utilities that provide essential service to the economy. However, we consider that the proposed credit treatment remains too restrictive, and that the category should be expanded to include other exposures.

LGD treatment

The ABA recommends that within the category of 'Exposures with eligible recovery value', senior exposures to operators of large public infrastructure or utilities that provide essential services to the economy should be subject to a 40 per cent LGD, noting this aligns to the Basel senior unsecured LGD for corporate exposures. The key difference to APRA's current proposal being that the haircut would not apply.

This is the most appropriate treatment given that a higher rate of recovery is expected and would extend to senior unsecured exposures (i.e., not be limited to those that are secured). The exposures are likely to recover at a higher rate due to:

- the fact that they have large fixed-asset bases that produce significant cash flows protected by regulatory authorities, and
- that they provide essential services (which means they are more likely to operate through a bankruptcy process and/or receive government support).

This proposal is summarised below:

LGD Category	LGD (%)	Haircut (%)
Eligible recovery value (physical or financial collateral)	FI: 45% Corporate: 40%	40%
Eligible recovery value (water entitlements)	FI: 45% Corporate: 40%	40%
Senior exposures to operators of large public infrastructure or utilities that provide essential services	40%	N/A

Recommendation

The ABA recommends that APRA remove the proposed collateral haircut of 40 per cent for senior exposures to operators of large public infrastructure or utilities that provide essential services.

Expansion of the category

The ABA submits that this category should apply to sovereign entities, as well as be broadened to include several additions outlined below.

Collateral Type	Rationale
Licences (e.g., hotel or liquor licences)	These licences are often transferrable and have significant value in the event of default.
General Security Interest (**GSI**) over other types of collateral	GSIs provide an ADI with a security interest over all current and future assets of a business. They also provide the following benefits: • rights to realise the assets covered by the security • allows the bank to appoint a receiver, manager or administrator • enables enforcement of contractual rights against a third party (such as a tenant with an unregistered lease)

	• eliminates any uncertainty as to whether the chattels that form part of a building that the bank has a mortgage over can be included in a sale, and • elevates creditor status above an unsecured creditor.
Rate Revenue	The security over rate revenue is common in the public sector (e.g., against city councils that are typically unrated) and it is registered on PPSR (Personal Property Securities Register). The benefit of having the security in place is that the debt will have priority to be satisfied in full before any other unsecured creditors.
Other financial assets, such as diversified pools of loans or fund equity interests and fund uncalled capital commitments	Financial assets that do not meet the criteria for recognition as Eligible Financial Collateral or Eligible Financial Receivables similarly have significant value in the event of default. For example: • security over diversified pools of loans and portfolios of independently managed private equity limited partnership units have access to strong established secondary markets, and • security over fund uncalled capital commitments represent claims against third party investors typically of strong credit quality (e.g., pension funds).

Recommendation

The ABA requests that APRA expand the category 'Exposures with eligible recovery value' to include licenses, senior exposures that have a general security interest, rate revenue, other financial assets and other senior exposures that include energy, resource extraction, telecommunications or economic infrastructure.

Definition of essential service

APRA has indicated that an essential service is a service which has a tripartite agreement with the Commonwealth or is valued based on the regulatory asset base (**RAB**). The ABA submits that this definition should be further expanded and clarified by APRA.

The ABA considers it is important that any definition captures ancillary services that are vital to the provision of the essential service to customers. For example, the following services should be captured:

- Leasing of equipment to support essential services (e.g., energy meters to a retail energy supplier).

  These services have high recovery rates even though the supplier may not meet the definition of an 'operator of an essential service', e.g., because it does not have a regulatory asset base. The high recovery rate on the exposure is instead driven by the critical nature of the equipment and the regulatory framework (for example, the need to measure customer usage of electricity and a regulatory framework that ensures the customer has access to electricity).

- Registry businesses that are the exclusive providers of land title registration services (granted by way of long-term concession agreements with state and territory governments).

  Assignment of such facilities to the 'Exposures with eligible recovery value' category will result in a material increase in the LGD applied to these exposures that have a strong security position over stable assets (including a tripartite agreement with the relevant state or territory government which provides financiers with step-in rights on enforcement).

Recommendation

The ABA recommends that APRA provide additional guidance around the definition of 'essential service' and the types of exposure eligible for the lower LGD to ensure that such exposures are appropriately captured in this category.

C2. Conditions precedent

Material conditions precedent

APRA position

In its July 2021 update, APRA set out that it intends to include the following clarifications in APS 112 regarding the definition of conditions precedent:

"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".

The ABA accepts APRA's position that exposures with conditions precedent may result in a credit exposure and therefore should be generally treated as commitments. However, we request that APRA make an exception for exposures where material third-party conditions precedent is evident.

We propose to exclude transactions subject to material conditions precedent from application of the definition of commitments. As soon as material third-party conditions precedent are satisfied (even if other conditions remain outstanding), the commitment would then be recorded.

Examples of lending where material conditions precedent may occur include:

- corporate mergers and acquisitions, including successful bids in public auction, acceptance required or level of acceptance by target, regulatory or court approval of scheme of arrangement
- development finance requiring regulatory or environmental approvals
- privatisation where government acceptance of the bid or subject to regulatory approval
- public private partnership or concession-based project requiring nomination of preferred proponent, execution of concession agreement.

This alternative treatment is proposed because it is important for ADIs to continue to support transactions with material conditions precedent to assist economic development. We note that this is a significant issue that needs to be resolved given that such commitments are often large and may be outstanding for long periods of time.

Recommendation

The ABA recommends APRA exclude transactions subject to material conditions precedent from application of the definition of commitments. As soon as material conditions precedent are satisfied (even if other conditions remain outstanding), the ABA propose the commitment is to be recorded.

AML/CTF requirements

A separate but related issue revolves around Know Your Customer (**KYC**) requirements, primarily impacting new-to-bank entities. Section 32 in part 2, division 4 the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (**AML/CTF Act**) prohibits ADI from opening any accounts until KYC is completed. Given the above legislative requirements, an offer made by an ADI offer is conditional upon all regulatory KYC requirements being met. Until these are satisfied, the ADI is not able to provide any banking facilities or open bank accounts.

Recommendation:

The ABA recommends that the commitment is not recorded until KYC provisions have been satisfied. Any other treatment may lead to ADIs being non-compliant with the AML/CTF Act.

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Master agreements

APRA position

In its July 2021 update, APRA set out that it intends to include the following clarification in APG 112 regarding the treatment of master agreements:

""An arrangement that does not advise a lending limit, and only stipulates the terms and conditions of future trades and limit establishment, does not generally constitute a commitment".

The ABA requests that APRA provide clarification in its prudential guidance as to what it means by the phrase "does not generally include" to facilitate consistent application across the industry. This could be achieved by deleting the word "generally" or by providing examples of when such arrangements should be treated as a commitment. The ABA would also welcome further discussion on this in an industry workshop on commitments.

Self-liquidating trade facilities

APRA position

The proposed exclusion from the definition of commitment includes the following requirement:

"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."

The ABA understands the purpose of including this requirement in the prudential standard. However, we submit that there should be an exception allowed for self-liquidating trade facilities. Trade finance is operationally complex and involves the execution of trades across varying time zones. Inserting a requirement for an independent third party to decide to drawdown for an uncommitted facility could result in unnecessary delays and customers missing a valuable opportunity.

Recommendation:

The ABA recommends APRA exclude self-liquidating trade facilities from the independent decisioning requirement. All the other requirements under Draft APS 112, Attachment C, paragraph 3 would remain in force.

C3. IRB RWA scaling factor

APRA position

In December 2020, APRA proposed an IRB scaling factor of 1.1 to calibrate outcomes consistent with the unquestionably strong capital benchmarks. This scaling factor would be applied to RWAs for all IRB asset classes under APS 113. In its July update, APRA proposed to revise the IRB scaling factor to 1.05 and indicated that it may revisit this further because of the QIS.

The ABA welcomes moderation of this scaling factor from the previous proposal. However, we remained concerned with the proposal to apply the IRB scalar to specialised lending (project and object finance), given that such exposures are exempted in the current framework and are in the process of being removed from Basel framework requirements.

We request that APRA seek to align its capital requirements with Basel, with any divergence well-justified and made on a transparent and comparable basis. Failure to do so would have a negative impact on Australian ADIs that operate in direct competition with international peers. In particular, the application of the IRB scalar to specialised lending (project and object finance) has potential to impact the ability of Australian ADIs to lend to long-term infrastructure and industrial projects that have access to international markets.

Recommendation:

The ABA requests that APRA removes the IRB scaling factor for specialised lending.

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C4. Trade finance

The ABA recognises that industry has participated in ongoing discussions with APRA surrounding the appropriate treatment of LGD for trade finance facilities. We respectfully request a targeted workshop with APRA to continue this discussion in light of the revisions to the capital framework.

As a starting point, the ABA has outlined the principles that industry would use to classify trade finance transactions as self-liquidating. Industry intends to classify trade finance transactions as self-liquidating if the exposure is extinguished directly due to:

- the buyer or supplier having fulfilled their contractual obligations, or
- the sale proceeds having been transacted and paid directly to the trade finance exposure.

In such transactions, there must be:

- clear visibility over the underlying supply or offtake contracts to ensure they match the terms of the trade finance exposure
- controls in place to ensure payment terms are met on date of the contracted maturity
- payment made to an account with the ADI to directly extinguish the trade finance exposure, and
- controls to ensure that the underlying repayment source (receivable) cannot be on-sold.

C5. Subordinated debt

APRA position

The draft APS 112 adopts a new definition of subordinated debt, with a risk weight of 150 per cent for holdings of subordinated debt issued by commercial (non-financial) entities. In its July update, APRA signalled its intention to include economic subordination within the definition of subordinated debt. It plans to provide further guidance on the definition of economic subordination in the revised APG 112 and APG 113.

APRA intends to update APS 112 Attachment B (paragraph 33) with the following: "Subordinated debt includes any facility that is expressly subordinated to another facility, or has the effect of conveying economic subordination to another facility. Subordinated debt that is not required to be deducted from regulatory capital under APS 111 must be risk weighted at 150 per cent".

While the industry is grateful for the additional feedback that APRA has provided, we request a workshop with APRA in order to provide much-needed clarity to industry on issues such as:

- specific lower-level definitions
- consideration of a threshold for senior debt and prior indebtedness to limit application to material subordination
- consideration for risk mitigation through diversified asset base and cash flow streams, and
- applications for different industries, particularly finance and insurance.

C6. External ratings

APRA position:

APRA has amended APS 112 to be more consistent with the Basel framework by introducing the requirement that ADIs should not use external ratings for bank counterparties that include uplifts for implicit government support.

This requirement would require ADIs to obtain the rating agency reports from Standard & Poor's (**S&P**), Moody's and Fitch for the available ratings and then strip out the "implicit government support", which can be operationally onerous and costly to perform across the large number of bank customers. Using S&P as an example, there are four types of support, including sovereign support which can be implicit

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or explicit and which is not always clearly defined in the report. The rating methodologies are also different across three rating agencies which complicates the process further.

The ABA believes that ratings incorporating implicit government support are entirely appropriate to risk weight bank exposures and do not understand the rationale for its exclusion. We note that excluding implicit government support is not currently the market practice for external credit assessment institutions and are concerned that the risk weight associated with a 'stand-alone' credit rating would be overly punitive.

Recommendation:

The ABA seeks clarification from APRA on the removal of "implicit government support" from the external rating published by rating agencies. To ensure consistency across the industry, further guidance on what constitutes "implicit government support" is needed, including guidance on what needs to be removed from published external credit ratings.

External ratings for SME borrowers

APRA is proposing to require ADIs to check SME borrowers for external ratings, as well as instances where an SME borrower is guaranteed by an externally rated entity (and the eligible guarantee requirements are met). Given the large number of customers in the SME segment, this requirement will result in significant operational difficulties around data capture and mapping, both initially and ongoing.

The burden imposed on ADIs from the implementation of this proposal far outweighs the small number of SME borrowers that might be found to have an external rating. In addition, it is not entirely clear what risk weight would apply if an SME customer was not checked for an external rating. Applying the worst externally rated risk weight may impact the ability of ADIs to lend to SME borrowers, given that the unrated risk weights are 75 percent to 85 per cent versus 150 per cent for the worst external rating band.

Recommendation:

The ABA recommends that APRA remove the requirement to capture external ratings from SME borrowers, and that exposures to these borrowers be subject instead to a 75 per cent and 85 per cent risk weights respectively when they are eligible to be treated in this part of the APS 112 standard.

In addition, we recommend that APRA rename and change the ordering of Attachment B to refer to "Small and medium-sized enterprise exposures and unrated exposures" as the first category of exposures discussed in the "corporate exposures" segment to make it clear that there is no requirement for ADIs to check for external ratings for SME borrowers.

C7. Commercial property

APRA position

In its July update, APRA outlined its intention to allow ADIs to use commercial property in the LVR calculation for mixed collateral exposures, subject to a 40 per cent haircut on the value of the collateral. This approach recognises the value of the commercial property, but with a haircut to reflect the greater risk of this collateral compared to residential property.

The ABA welcomes APRA's position on this issue. However, we would like to highlight another element of commercial property valuation that requires attention from APRA.

A significant proportion of high value commercial property assets are subject to either:

- joint ownership arrangements. These may be situations where the property is owned by a unit trust and therefore the ADIs is not able to obtain a registered first mortgage over the property. To mitigate this risk, such arrangements may be treated as secured commercial property transactions, whereby a charge is taken over the units owned by the bank customer (with a side deed entered into with other joint owners and the trustee of the unit trust). This results in the bank securing rights akin to those of a first mortgagor; or

- lease hold arrangements, where the ADI can take a mortgage over the lease to provide it with rights akin to those of a first mortgagor over real property.

Recommendation:

The above scenarios would not meet the current wording of APS 112, Attachment A, paragraph 4. The ABA proposes that APRA allow the capture of these transactions as secured commercial property transactions for LVR purposes.

C8. Public sector entities

APRA position

In its July update, APRA clarified that IRB ADIs would include domestic public sector entities (**PSEs**) in the definition of financial institution under APS 113. ADIs would also apply an asset value correlation multiplier set to one in calculating RWAs arising from exposures to domestic PSEs.

The ABA is grateful for this additional clarification. However, we seek additional guidance as to the proposed treatment of the following categories:

- Government schools.
- Government hospitals.
- Government aged care facilities.
- Corporate Commonwealth entities, such as Australia Post.
- Government fund managers or property trusts.
- Agencies, statutory authorities and bodies created to enable legislation.

In particular, the ABA would appreciate guidance on whether there are qualifying criteria that ADIs should apply in determining whether an entity is classified as a public sector entity, including any consistency with definitions used across other prudential standards (such as the definition of Government related entities under APS 221: Large Exposures). For example, such criteria may include whether the entity has an independent board or is unconditionally guaranteed by the Government.

The ABA also seeks to understand:

- whether the definition is limited to PSEs in Australia, or whether it also includes NZ domestic PSE reported at level 2 in Australia and/or lending in the UK or US to local PSEs.
- the assignment of domestic PSEs to the financial institution asset class under APS 113. We propose that the wide range of entities falling within this category would continue to be internally risk managed in accordance with their principal industry or business activity and would not be assigned supervisory LGD parameters applicable to financial institutions under the FIRB approach (unless they are considered to be financial institutions).

C9. Predominance test for exposures with multiple securities and loans

The ABA seeks clarity as to how the predominance test is to be applied for exposures with multiple securities attached to multiple loans. There are several different ways to calculate predominance for scenarios including many-to-many relationships, aggregated accounts with split predominance and internal and external charges.

The standard covers the treatment of simpler scenarios, but it is not clear on the more complex scenarios described. This can produce very different predominance and LVR outcomes dependent on which methodology is used. As a result, there is a risk that varying results will arise across the industry.

The following example seeks to illustrate different options to arrive at the property asset class. The three loans in the table below are all secured by a mix of properties which are interlinked between the loans. The predominance is then calculated using three different methods:

- **Method 1**: Determine predominance based on property value only.[17]
- **Method 2 (*Industry preferred*):** Determine predominance based on allocated collateral value.
- **Method 3:** Consider the multiple loans as a single (aggregated) structure and determine the predominance for the whole structure.[18]

Loan		**Loan Collateral**				**Method**		
#	**Amount $m**	**#**	**Type**	**Value $m**	**Allocated collateral value $m**	**1**	**2**	**3**
1	200	1	Res	120	75	120 res	75 res	120 res
		2	ADC	110	30	110 ADC	30 ADC	110 ADC
		3	Comm	100	100	100 comm	100 comm	100 comm
Outcome – what is predominant in loan 1?						**Residential**	**Commercial**	**Residential**
2	80	1	Res	120	45	120 res	45 res	120 res
								110 ADC
		2	ADC	110	50	110 ADC	50 ADC	100 comm
Outcome – what is predominant in loan 2?						**Residential**	**ADC**	**Residential**
3	20	2	ADC	110	30	110 ADC	30 ADC	120 res
								110 ADC
								100 comm
Outcome – what is predominant in loan 3?						**ADC**	**ADC**	**Residential**

The preferred industry approach, Method 2, reflects allocated collateral value and as such is considered a more precise method of determining predominance based on the security used for each loan. It is recognised that this may be a more complex calculation in some cases and introduces a new concept (allocated collateral value) into the property asset class. The allocated collateral amount is the partitioned amount of total security value is allocated to each individual loan when multiple loans are structured. Based on this allocated amount, the predominant security of each loan will then be determined for regulatory reporting.

The ABA considers that it is important for predominance to be calculated at an exposure level, rather than at an aggregate level (i.e., Methods 1 or 3). There are significant implications if predominance is considered at a non-exposure level. Applying an aggregate test could lead to residential mortgages being classified as commercial property exposures. This would result in flow-on implications requiring these loans to be tested as commercial property exposures which may be operationally difficult for retail mortgages. For example, it would be difficult to apply the requirement in APS112, Attachment A, Paragraph 5(d) that stipulates:

"…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."

C10. Second mortgages

APRA position

Paragraph 4 C), Attachment A of draft APS 112 requires:

[17] That is, only use the securities directly linked to that loan.
[18] That is, all three loans take all three securities into consideration.

"…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)."

The ABA seeks clarity on the intended treatment of second mortgages given the requirements articulated above. It is not clear whether any second mortgages could meet this requirement, given the rights of the first mortgagee. We seek clarity as to whether there is a general expectation from APRA that a proportion of second mortgages across the industry may meet the requirements to be classified as a standard loan, and, if so, what may qualify them to do so.

Appendix D: Related prudential and reporting standards

This appendix outlines issues with related prudential and reporting standards:

D1. Alignment with EFS

D2. Net Stable Funding Ratio

D3. Aggregation of counterparties

D1. Alignment with EFS

The ABA queries the intended alignment of definitions between the Reserve Bank of Australia's Economic and Financial Statistics (**EFS**) and the draft prudential standards, APS 112 and 113. For example, the industry has identified the following areas of divergence in relation to the definition of owner-occupied loans.

Trusts

- **EFS:** All non-natural entity mortgages, including residential mortgage accounts held by trusts (e.g., family trusts, personal superannuation funds), are classified in the 'Business' loan type and not the 'Housing' loan type. As owner-occupied loans in EFS are a further sub-set of the housing loan type, residential mortgage-held trusts cannot be included as owner-occupied loans under EFS definitions.
- **Draft APS 112:** Residential property held by non-natural persons (e.g., family trusts) can still be classified as owner-occupied loans under the residential property asset class provided the loan is not for business purposes.
- **Draft APS 113:** Exposures secured by residential real estate can be classified as retail residential exposures, including those held by trusts, provided they are not for business purposes and meet certain other conditions. If the EFS definition were to be used, then these loans to family trusts would be classified as SME lending.

Mortgages in credit balance

Under EFS, mortgages that are in credit balance are treated as deposits and included in the 'Personal' loan type category and not the 'Housing' loan type category. As a result, an 'Owner Occupier' / 'Investor' status is not assigned to these loans, as such a status is only calculated for loans in the 'Housing' loan type category. This differs to treatment under draft APS112 and draft APS113.

Recommendation

The ABA recommends that APRA does not seek to align the definition of owner-occupied loans under APS 112 and APS 113 to the definition specified under the EFS.

D2. Net Stable Funding Ratio

The ABA's view is that that changes in the risk weights being proposed by APRA will have a material impact on the calculation of the net stable funding ratio (**NSFR**) under APS 210: Liquidity (**APS 210**). APS 210 refers to APS 112 and uses the Standardised risk weights outlined in APS 112 to determine the level of required stable funding for each mortgage. The ABA has concerns that the proposed standardised risk weights may impact the NSFR under the current proposals. The ABA does not consider a tightening of the NSFR is the intent of the Basel changes, and request that APRA ensure that this is not an unintended consequence.

Recommendation:

The ABA recommends APRA recalibrate the NSFR calculations when it undertakes a revision of APS 210 to ensure that the NSFR remains the same as today.

D3. Aggregation of counterparties

As expressed in our previous submission in April 2021, the ABA holds concerns with the requirement for financial statement data to be aggregated as per APS 221. APRA has aligned the definition of 'connected borrowers' to the group of connected counterparty requirements within APS 221 for the calculation of asset classes.

We acknowledge that APRA is simplifying its framework by aligning definitions across related components within its risk framework. However, we have concerns with the use of two components of the APS 221 framework for capital calculation purposes:

1) the adoption of economic interdependence (**EI**) requirements; and
2) structured vehicle additional risk factor (**SVARF**) connections.

Economic interdependence can drive unintuitive asset class allocations because a group of connected counterparties exists if an economic interdependence relationship exists. An example of this is a bus company who has a long-term NSW government contract which comprises more than 50 per cent of their income. Under APS 221, this bus company would be aggregated with the NSW Government. Under APS 113, this could imply that the bus company would be classified as a sovereign entity. The complications with this classification are:

- The bus company does not have the same risk characteristics as a sovereign entity. The minimum requirements as they apply to sovereigns, in terms of their assessment and rating process would not be appropriate for the bus company.
- Within the sovereign asset class, the supervisory LGD estimate would also apply to the bus company, even though its risk characteristics are likely to be different to the NSW Government.

Recommendation:

The ABA recommend APRA remove the requirement to group connected borrowers as per SVARF connections and EI provisions. Instead, grouping should be based primarily on material control, influence and, or majority ownership.

The ABA also recommends that the revenue used to determine SME Retail and SME Corporate eligibility and application of the firm-size adjustment is determined based on:

- the information used to determine the Probability of Default (**PD**) for each borrower in a connected counterparty group (excluding those connected due to SVARF and EI), and
- the highest turnover recorded against the borrower in the connected counterparty group.

This will reflect the information that is available to ADIs at origination as well as information included in the borrowers' reporting undertakings.