Australian Banking Association

30 April 2022

General Manager, Policy
Australian Prudential Regulation Authority

By email:

Dear ,

Finalisation of the Prudential Practice Guides (110, 112 and 113)

The Australian Banking Association (**ABA**) welcomes the Australian Prudential Regulation Authority's (**APRA**) ongoing engagement with industry regarding the development of the revised capital framework. To assist APRA finalise the prudential practice guides (APG 110, APG 112 and APG 113), industry provides the following feedback in response to:

1) the materials presented to the industry in the APRA-ABA workshop on 8 April; and
2) the subsequent queries to industry on 19 April.

The ABA would welcome the opportunity to work through the detail of this letter with APRA as well as the additional items included in APRA's written indicative response provided on 28 April before finalisation of the APRA prudential Practice Guides. Two areas which industry would like to discuss include the treatment of Credit Risk Mitigation and the determination of consolidated revenue where the ADI does not have recourse to all borrowers in the Group.

Key issues

1. **Maintaining retail modelling and management for borrowers with more than four investment properties:** Borrowers with a large number of investment properties pose a concentration risk which is not accommodated for in the current framework. The ABA believes it is appropriate to reflect this risk in the capital held for these loans, but not to change the modelling or customer management of these loans to a non-retail based methodology which would have significant implications for retail customers.

2. **Recognition of property backed guarantees in the LVR calculation under APS 112**: Property Backed Guarantees are used as a legal means of linking a third party mortgage/property to a borrower. These guarantees do not have explicit recognition under the new APS 112. As the property backed guarantee is economically equivalent to a mortgage over the property, the ABA believes it is appropriate to allow recognition of the guarantee in the LVR calculation.

3. **Providing flexibility to allow banks to recognise half-exits in the calculation of default rates, only where Banks do not have data on refinances and matured exits**. This would provide a consistent industry treatment where full compliance to the prudential practice guide cannot be achieved.

4. **Allow the use of consolidated exposure size and non-complexity of the product/counterparty on more than an exception basis for SME Retail classification**. This would limit obtaining financial statements for small business customers.

5. **Continue engagement with the industry on the classification of infrastructure assets within the framework**: This work will be de-coupled from finalisation of prudential practice guides to promote industry consensus application of definitions, appropriately attribute value of infrastructure assets, calculations of LGD's and avoid unintended consequences to this portfolio segment.

As noted above, the ABA would welcome the opportunity to discuss the content of this letter in detail with APRA in the coming weeks. This may also present an opportunity for industry to provide feedback on the additional items contained in APRA's, 28 April, written indicative responses.

I will contact you in the coming days to organise a follow meeting. In the meantime, please do not hesitate to contact me.

Regards,

Policy Director
Australian Banking Association

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.

Appendix A: Additional information

1. IPRE Definition (More than Four Investment Properties)

Customers with more than four properties pose a concentration risk which is currently not accommodated for under the capital framework. As a result, APRA is proposing to treat these customers as Income Producing Real Estate (IPRE) exposures. The ABA acknowledges APRA's concerns but does not believe that just the number of properties is in itself sufficient to define the IPRE customers – loan purpose and primary income dependence are also driving factors. That being said, the ABA believes the risk can be reflected by increasing the capital outcomes to reflect the increased risk. However, banks do not believe adjusting operational processes to treat these clients as 'Non retail' exposures will deliver the optimal Risk and customer outcomes and as a result propose to maintain the existing retail customer and modelling treatment. Options include:

Option 1

ADIs acknowledge APRA's concern that retail borrowers with a high number of investment properties may pose risk that is not explicitly captured in the prudential standards.

ADIs do not believe that an investment property count is in itself sufficient to justify an IPRE classification – that determination should remain anchored in the prospects for repayment of the exposure depending primarily on the cash flows generated by the asset or other real estate assets owned by the borrower.

In the absence of APG text these investment loans would have received a 1.7 multiple in the APS 113 RWA calculation. A logical way to reflect any additional risk is to embed a "higher RWA multiple" for investment loans to borrowers with more than four investment properties where they meet the requirements under Paragraphs 23 a) & 23 b) in Draft APG 113. This would allow the appropriate capital outcome without needing to change the regulatory asset class to IPRE. The exposures would continue to be identified and managed as retail residential mortgages.

This approach would prevent any unintended obligations that may result from tagging these exposures as IPRE, for example, the need to take them through Property Risk Assessment Models or aggregating them for the purpose of SME asset class identification.

Under APS 113 Attachment A, paragraph 8 IPRE exposures are subject to an additional 1.5 scalar. Under this option industry proposes adopting a 'higher RWA multiple' of 2.5 to reflect the IPRE scalar and the 1.7 scalar as investment loans.

Option 2

To reflect IPRE calculation with a 1.5x multiple for exposures to borrowers with more than four investment properties and meet the requirements under Paragraphs 23 a) & 23 b) in Draft APG 113, while retaining original retail asset class segmentation for model use / default definition, approach to retail customer management and SME classification. ARF and APS330 reporting as IPRE.

Option 2 acknowledges APRA requirements pertaining to capital calculations while minimising material operational issues associated with retail exposures being classified with non-retail parameters.

Area	Proposal	Rationale
Capital Treatment	**Option 1:** Additional 1.5x scalar to be applied to retail exposures to reflect IPRE credit risk weight for customers with more than four investment properties. Exposures will continue to be captured under Retail Residential Mortgage asset class	The capital will increase for this population to reflect the higher concentration risk. Specifically for **Option 2**: ADIs will continue to capture rental information for the investment property at the point of origination which will serve as revenue input for the firm size adjustment. However, this revenue information will not be aggregated with the revenue from

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	and hence will use retail RWA curve for this asset class. **Option 2:** Apply IPRE calculation methodology for impacted retail exposures. Exposures will be captured under IPRE asset class and hence will utilise the corporate RWA curve incorporating maturity, EAD and firm size adjustment for SME.	borrowers associated commercial business (if any) as the investment property lending is not considered business purpose. Please refer to the section - Customer Management.
Modelling & Definition of Default	Treatment same under both **Option 1** and **Option 2:** Maintain Retail Modelling treatment and definition of default	ADIs believe existing retail models are fit for purpose for this segment of customers. • Additional data collection would be required to utilise non-retail models • Materiality of this segment will only be known once data is collected for cross ADI exposures. • Product structure and default definitions are consistent with the home loan portfolio. • Risk for this segment is more concentration risk as opposed to default risk, industry believes using the existing models is appropriate in the interim.
Customer Management	Treatment same under both **Option 1** and **Option 2:** Maintain Retail Customer Management	Retail customers with more than four mortgaged properties are currently managed in the retail portfolio. If industry was required to manage customers as non-retail then the customer and the loan contracts would need to be managed differently to facilitate: - Gathering of data to conduct annual reviews (including financial information); - Gathering of revenue data every 3 years (if the aggregate exposure size > $5m); - Gathering the customer's relationships to assess the exposure and revenue across the 'connected group of borrowers'; - Managing collections and default on a borrower basis (including aggregating all customer's retail exposures). This would require cross default clauses in a customer's contract.

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		There would be a significant impost on a retail customer to comply with these non-retail requirements. Additionally, if a customer moves into the IPRE segment due to the acquisition of an additional property, existing and new loans will need to be moved onto new contracts in order for the Group to meet the Non-Retail requirements above. As a result the ABA recommends maintaining the management of these customers as Retail.
ARF and APS330 Reporting	**Option 1:** Undertaken on asset class of origination (i.e. residential mortgage) **Option 2:** IPRE	**Option 1:** Operationally efficient to retain reporting within the retail asset class of origination. **Option 2:** Alignment of reporting with calculation adds additional operational complexity
Requirements for Retail SME criteria	Treatment same under both **Option 1** and **Option 2:** Maintaining as retail exposures for purpose of SME allocation	In line with the proposal on customer management, these exposures will not be treated as exposures for business lending and hence will not be applicable for the following: - Total business-related exposure for the borrower - Consolidated annual revenue for a group of connected borrowers - Borrower or exposure complexity
Implementation	Treatment same under both **Option 1** and **Option 2:** Grandfathering the Back-book	The industry is supportive of APRA's proposal to grandfather the back-book from this treatment until there is a new origination or refinancing. This will have operational benefits for existing customers who had their exposures originated prior to the change in standards.

2. Property Backed – Guarantees

Property Backed Guarantees are used as a legal means of linking a third party mortgage/property to a borrower. This method of linking mortgages/property is common in retail and business banking and occurs when the operating business, borrowing and/or security property are in different names.

Below are two common examples of where these are used:

- A small business, Borrower A, is seeking to provide collateral to her business loan under the company name B. Borrower A has a home in her own name but has no collateral under her company name. To secure the business loan by collateral, a property backed director's guarantee will be initiated which will link her home to her business loan.

- A member of a borrower's family seeks to provide additional collateral for a borrower's home loan. As the collateral is not in the borrower's name, the collateral is perfected by the family member linking the property to the loan by way of a guarantee.

New Standardised Approach to Credit Risk

There is no explicit recognition for property backed guarantees to individual borrowers under the new APS 112:

- APS 112 – Att A, para 13 states "*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*". This does not allow for recognition of the third-party guarantee within the LVR calculation.
- APS 112 – Att I only allows for the recognition of eligible guarantors which are limited to sovereigns, banks, other entities that are externally rated, and the Australian government. Guarantees provided by individuals or non-rated companies are not recognised and hence the CRM cannot be applied.

Both these paragraphs mirror the wording in the new Basel Framework, and are intended to ensure that an ADI does not 'double count' benefits from a guarantee in both CRM and in the LVR calculation. ADIs are not proposing ascribing a value for the underlying guarantee nor looking to substitute parameters or risk weights of the guarantee. Instead are using these arrangements more to look through the guarantee to the underlying collateral provided under the guarantee to be considered as part of LVR calculation. Without use within the LVR, the value of collateral provided under a guarantee will not be considered at all as guarantees are not eligible under APRA's CRM framework.

Under the current APS 112, the condition to not allow the recognition of guarantees in the LVR calculation does not exist. As a result banks currently take into consideration these property backed guarantees in:

- The classification of exposure within the residential mortgage asset class and/or application of retail risk weight parameters;
- As part of LVR calculations (including LMI qualification);
- As part of LGD measurement (for IRB banks).

Operation of the Guarantee in a default event

Property Backed Guarantees act legally and economically similar to a mortgage in the event of a default:

- A lender's priority of the security interest in real property is determined by the registration on title (subject to any external priority arrangements). This is true whether the security is provided by a borrower or a guarantor.
- A lender's right to enforce against the security is governed by the relevant agreements in place with either a borrower or guarantor.
- A guarantee generally operates to make the guarantor liable for the borrower's payment obligations under the guaranteed facility. The guarantee, therefore, makes the guarantor liable to pay outstanding amounts not otherwise paid by the borrower.
- In some circumstances, a lender may be required to pursue the borrower and any security provided by the borrower first before pursuing the guarantor and security provided by them. However, this does not affect the lender's priority interest in security provided by the guarantor or their ability to ultimately recover amounts outstanding from the guarantor through the security.

Consider the following two scenarios:

#	Example	If Borrower A defaults…
1	Borrower A's facilities are supported by a Guarantee from B supported by a mortgage over B's property. B has no other debt.	- Payment would be sought from Borrower A for the amount in arrears with B as guarantor receiving a copy of the payment request; - If the Guarantor B cannot address the arrears position, then a letter of demand would be issued to B to commence recovery for the property. - Recovery proceeds would be applied as per the waterfall of mortgages. In this case as B has no debt, the proceeds would be used to repay Borrower A's debt, acting economically like a first mortgage.
2	Borrower A's facilities are supported by a Guarantee from B supported by a mortgage over B's property but B's property also supports B's home loan.	- As per above. - In this case as B has existing debt, B's home loan would be repaid first with the remainder used for Borrower A's facilities. - In this case the property backed guarantee acts economically like a second mortgage. However, this is simply a function of B's property having a separate first mortgage priority, as would apply in any second mortgage scenario.
Key Point: The mortgage over B's property has the same ranking and risk mitigating effect as any other collateral supporting the loan to A. The fact that it is a mortgage from a third party does not imply a lower priority. It is different to a second ranking mortgage where a senior ranking claim must first be satisfied.		

Recognition of Property Backed Guarantees in APS 112 LVR

Prior to the changes in the Banking Code of Practice and National Consumer Credit Code, Banks would commonly take a third party mortgage to link a third party property to a Borrower's loans[1]. As third party mortgages are no longer enforceable, ADIs use property-backed guarantees to capture these arrangements. As these have demonstrated value in the event of default, the ABA recommends that APRA should allow for their continued recognition in APS 112 LVR. Industry proposes that a statement be included in APG 112 clarifying that the property pledged via these guarantees is allowed to be directly incorporated into the LVR calculation.

APRA's Questions

In response to APRA's specific questions:

a) *What is the current practice for treating property-backed guarantees under the standardised approach?*

   Under the current APS 112, there is no restriction from including property backed guarantees into the LVR calculation[2].

   The current practice for IRB ADIs is to consider property backed guarantees in their LVR calculations and in the classification of exposure within the residential mortgage asset class and/or application of retail risk weight parameters.

[1] The NCC prohibits a credit provider from entering into a mortgage to secure obligations under a credit contract unless the mortgagor is a debtor under the contract or a guarantor under a related guarantee [ss 48(1) & (2)].
[2] APS 112 – Att A, para 13 is not present in the current standards

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b) *Are there any differences between Australian and overseas practices that would justify a different approach? (given the APS 112 wording mirrors the Basel requirements)*

In Australia, ADIs are unable to use third party mortgages as a mechanism to link a third party mortgage/property to a borrower. These arrangements are no longer recognised under the National Consumer Credit Code and Banking Code of Practice. Thus, Australian banks are required to obtain a guarantee from the security provider as a legal mechanism to "link" the mortgage to the underlying facility.

It follows that for non-Australian jurisdictions, if the equivalent banking code provisions are not in place, then all other things being equal, a separate guarantee will not be required (as was the case in Australia). By extension, industry believes that this provision under APS 112/ Basel will not be relevant.

c) To what extent is a property-backed guarantee economically and legally equivalent to a second mortgage?

There is no preferential ranking of collateral provided under a family guarantee (or similar) and unless a formal prior claim is in place (in which case it would be considered in the LVR), then there is no economic or legal equivalency to a second mortgage. Where no priority is given to any prior claim, ranking of collateral held under guarantee has no equivalency to a second mortgage noting the guarantee is a mechanism to link collateral only.

- Prior claims on collateral linked by guarantee, formalised with priority, will be considered within the LVR
- All pari passu claims on collateral will be considered within LVR calculations

3. Default Definition (removing half exits)

The ABA is supportive of APRA's documented approach, in the draft prudential guidance, of calculating default rates which remove exits for non-retail exposures excluding where the borrower:

- matured during the observation period rather than being refinanced;
- transitioned to the retail residential mortgage, QRR or other retail sub-asset class during the observation period;
- merged with another borrower (to which the ADI is also exposed) during the observation period; or
- the borrower defaulted during the observation period.

However, in the event that an ADI cannot distinguish matured customers from refinanced for a given non-retail portfolio, the ABA would also be supportive of adopting a consistent industry approach which would be to remove half of all exits. This hybrid approach provides a benefit to ADIs who can accurately capture data on exits but provides industry consistency where this information is not available.

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Appendix B: Additional considerations raised by the industry:

4. SME Definition

The ABA is supportive of APRA's clarification on the SME definition and the flexibility being allowed on the collection of financial statements for exposures less than $5m. In the SME Retail space, at time of origination, not all entities will have financial statements and not all deals will have financials recorded due to the nature or scale of the origination.

In cases where turnover is not available, smaller (<$1.5m) non-complex exposures should not be classed as Corporate and require a default treatment that allows them to be classed as SME Retail. The use of exposure size and non-complex nature of the product or counterparty for SME Retail classification would reflect the exposures accurately for regulatory reporting.

Furthermore, it would be very uncommon for entities with over $75m consolidated annual revenue to have SME Retail-sized exposures only at ADIs other than their main banking institution. If consolidated annual revenue was to be collected, this would result in a very low number of cases where a Retail SME exposure would need to move to the Corporate asset subclass.

Therefore, the ABA proposes the use of consolidated exposure size and non-complexity of the product/counterparty on more than an exception basis for SME Retail classification. This would limit obtaining financial statements to become an operational issue rather than having material capital impact.

5. Other Physical Collateral – Infrastructure Exposures

APRA's indicative policy position removes "other physical collateral" eligibility for concession, right to operate, or the asset owning entity and shares thereof (under FIRB and AIRB) on the basis of APS 113, Attachment B, paragraph 10 which recognises the likely lower loss given default on exposures to certain large public infrastructure assets or utilities that provide essential services to the economy. Further, APRA has proposed restrictions on eligibility for eligible recovery value based on tripartite arrangements by not intending to extend this definition to off-shore equivalents of tripartite arrangements and regulatory asset base due to complexity.

The industry is presently assessing eligibility of all other physical collateral and eligible recovery value for various collateral types (including concession, right to operate, or the asset owning entity and shares thereof) and note likely material LGD impact associated with the proposed positions:

- Infrastructure lending is heavily reliant on collateral valuations based on proposed exclusion criteria (Concession, right to operate, or the asset owning entity and shares thereof);
- Current AIRB LGD's are significantly lower than 40%/45% - appropriately recognising value associated with collateral position and low loss histories associated with infrastructure lending;
- Concession, right to operate, or the asset owning entity and shares thereof arrangements are likely to be of significantly greater value than many underlying (otherwise eligible) other physical collaterals and other collateral types (such as residential/commercial property) in many instances resulting in disconnect between FIRB and AIRB LGD outcomes;
- Large corporate infrastructure exposures calculated under FIRB are likely to be uncommercial due to 40%/45% LGD. Due to lending structures and counterparties seeking infrastructure funding, many are regulated utilities and large corporate counterparties likely to require FIRB methodology (and LGD) application;
- Other corporate infrastructure exposures calculated under AIRB are likely to be impacted by the AIRB floor; and
- Restriction to Australian tripartite / regulatory asset base arrangements directly impact current exposures originated within other ADI jurisdictions.

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ABA considers the proposed APRA position will have material industry level consequences.

- Lack of recognition of asset values (as reflected in proposed LGD's) will result in significant levels of current exposures being materially impacted; and
- Future infrastructure lending will be uncommercial, therefore resulting in material project price increases or locking Australian ADIs out of future projects.

In view of the potential materiality of impact, the ABA would like, as a priority, to undertake further engagement with APRA on other physical collateral and eligible recovery value definitions, eligibility and proposed LGD level to understand what would be required from the industry to support a review of the proposed APRA position.

The ABA would like to de-couple a review of other physical collateral and eligible recover value from finalisation of prudential practice guides to promote industry consensus application of definitions, appropriately attribute value of infrastructure assets, calculations of LGD's and avoid unintended consequences.