31 May 2022

General Manager, Policy
Australian Prudential Regulation Authority

By email:

Dear

Pragmatic implementation of APG 110, APG 112 and APG 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. Considerable work remains, both for industry and APRA, to finalise and implement these substantial reforms.

The ABA and its members cover two areas in this letter, with the aim to enhance consistency of implementation across the industry:

- To respond to items in APRA's 'ADI Capital Reforms - Indicative Views on Guidance' letter of 27 April; and
- To provide APRA with a proposed industry approach on common issues and challenges with the implementation of the new standards, also referred to as industry proxies.

The industry's response to items in APRA's letter of 27 April on Credit Risk Mitigation and determination of turnover for a borrower group can be found in Appendices A and B. Details of the first set of industry proxies, including industry's proposed solutions are included in Appendices C through to H. The ABA will continue to work with banks to identify and develop solutions to additional common issues and challenges that arise up until 1 January 2023.

Process for bank specific proxies

Some issues regarding the implementation of the capital frameworks reforms are likely to affect a single bank or subset of banks. As these are not industry wide issues, the affected banks will engage APRA bilaterally on these matters.

An articulation from APRA of its preferred method and timing of engagement, the information required and likely timing of a formal response, would assist banks to effectively and efficiently engage APRA to resolve these matters.

The ABA would also like to take this opportunity to re-emphasise the importance of the classification of infrastructure assets within the Other Physical Collateral framework, as highlighted in the ABA's 29 April 2022 letter to APRA. Industry appreciates APRA considering this issue and its broader economic implications.

If you require further information or would like to discuss any of the content of this letter, please do not hesitate to contact me on or .

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.

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Appendix A: Credit Risk Mitigation

Extract from APRA's 'ADI Capital Reforms – Indicative views on Guidance', 27 April 2022

2.2: APS 113 does not permit the application of credit risk mitigation to result in an adjusted risk weight that is less than a comparable direct exposure to the guarantor or credit protection provider. For the purpose of calculating the risk weight of a comparable direct exposure, can collateral offered by the borrower be recognised in the LGD?

Reference:

- APS 113 Attachment B, paragraph 49

APRA response: No. Regardless of the nature of the original exposure, the risk weight for a comparable direct exposure to the guarantor or credit protection provider would be calculated using the PD of the guarantor or credit protection provider, the LGD for an unsecured claim against the guarantor or credit protection provider and the risk weight function of the guarantor. If the guarantor or credit protection provider pledges additional collateral, this collateral may be reflected in the LGD used to determine the RWA for a comparable direct exposure.

Industry's view

APS 113, Attachment B, paragraph 49 states:

> "*the application of CRM in the form of guarantees and credit derivatives must not reflect the effect of double default nor result in an adjusted risk weight that is less than that of a comparable direct exposure to the guarantor or credit protection provider.*"

This condition applies to the Standardised, Foundation and Advanced methods of Credit Risk Mitigation.

APRA's response indicates that an ADI can either:

- Recognise the RW of the exposure to the borrower; or
- Recognise the RW of an unsecured direct exposure to the guarantor.

If there is collateral provided by the borrower, this is not recognised in the application of Credit Risk Mitigation.

The ABA consider the proposed credit risk mitigation interpretation does not accurately recognise and measure the risk inherent within the total arrangement. The ABA would instead interpret a '*comparable direct exposure to the guarantor or credit protection provider*', including recognition of the security provided in the underlying exposure – provided there is no subrogation of collateral rights.

Consider the following stylised example:

Customer A has a $100 loan that is fully guaranteed by Customer B. Loan A is supported by commercial property security of $50.

Loan A to Customer A	Guarantee from Customer B
• Exposure = $100 • Security = $50 • PD = 1% • LGD = 35% • RW = 65%	• Exposure = $100 • Security = 0 • PD = 0.4% • LGD = 50% • RW = 60%

Under Attachment B, paragraph 49, a risk weight of 60% would be adopted if a bank was to apply the proposed APRA approach – noting this does not result in an adjusted risk weight less than that of a comparable direct exposure to the guarantor.

ADIs typically do not subrogate collateral rights when seeking eligible Guarantees and therefore have unfettered right to security in event of default of the borrower. When assessing LGD estimates, collateral provided must be considered where an ADI retains access to underlying collateral which impacts both exposure covered/uncovered by eligible guarantees.

The risk of the stylised example is substantially lower. In the event of default for this example:

- ADI realises security (for example, $50);
- ADI call on the Guarantee for the remainder of the debt ($50).

Only in the event of default of the Guarantor would the ADI encounter a loss. In other cases, an ADI may call on the Guarantee first before looking to realise the security. However, in both cases the ADI has recourse to both the security and the guarantee.

For Advanced Banks, APS 113 Attachment B, paragraph 54 allows ADIs to '*recognise the risk-mitigating effects of guarantees and credit derivatives by adjusting either PD or LGD estimates'*. Banks would typically measure the risk of this arrangement by:

- Adjusting the PD to reflect the reduction in default risk from the presence of the guarantor.
- Maintaining the LGD to reflect the security provided by the borrower which also reduces the loss in the event of default.
- In the case of a FIRB eligible guarantor, LGD would be reassessed using FIRB LGD measurement parameters

The ABA considers a comparable direct exposure the Guarantor to consider all transaction arrangements, inclusive of any collateral remaining relevant for exposures covered (or remaining uncovered) under arrangements that include an eligible Guarantor. The risk weight would be lower due to the influence of the guarantee but still reflect the exact parameters of the comparable underlying transaction.

Using the stylised example above:

Loan A to Customer A	Guarantee from Customer B	Post CRM outcome
• Exposure = $100 • Security = $50 • PD = 1% • LGD = 35% • RW = 65%	• Exposure = $100 • Security = 0 • PD = 0.4% • LGD = 50% • RW = 60%	• Exposure = $100 • Security = $50 • PD = 0.4% • LGD = 35% • RW = 41%

The resultant risk weight more appropriately considers credit risk mitigation arrangements without providing for an adjusted risk weight lower than a direct comparable exposure to the guarantor

APRA's proposed interpretation ignores key features of the underlying transaction or a direct exposure to the guarantor with the following unintended consequences:

- It does not incentivise the taking of security from the borrower where there is an unsecured credit risk derivative or guarantee in place;
- In many cases, an unsecured exposure to a Guarantor could result in a higher risk weight than the underlying collateralised transaction therefore making it uneconomic to seek credit derivative, credit insurance coverage or risk mitigating effects of an eligible Guarantee.

Proposed industry approach

Industry proposes to allow for recognition of collateral provided by the borrower in the LGD for Credit Risk Mitigation purposes.

Appendix B: Asset Class Determination – Consolidated Annual Revenue of a Group of Connected Borrowers

Extract from APRA's 'ADI Capital Reforms – Indicative views on Guidance', 27 April 2022

3.2: For the purpose of determining the consolidated annual revenue of a group of connected borrowers, can an ADI only consider borrowers within a group to which the ADI has recourse?

Reference:

- APS 113 paragraph 14
- APS 113 paragraph 40
- APS 113 Attachment A, paragraph 6

APRA response: Whether or not an ADI has recourse to all entities within a group is generally not relevant for the definition of a group of connected borrowers. Having recourse to only part of a group does not obviate the need, under APS 113, to collect and use the consolidated annual revenue of the group.

Industry's view

The requirement to obtain financial statements to measure consolidated annual revenue of an entire connected group, including entities to which an ADI does not have recourse, poses considerable operational challenges, resulting in divergence within financial data used in determining the IRB asset class of a borrower(s) and assignment of PD ratings to the borrower(s) to which the ADI is exposed.

Specific challenges posed by this guidance include:

- Where an ADI does not have recourse to an entire consolidated group of a borrower (or related-party guarantors), consolidated revenue for the full connected group is unlikely to be available. Financial information available to an ADI in these circumstances will typically be financial statements of entities to which it has recourse with this financial information used in the determination of the PD rating of the borrowers.

  This limitation is particularly relevant for unlisted SME and Corporate borrowers, where audited financial accounts are unlikely to be publicly available and typical origination processes and facility agreements only require the provision of financial data on those entities to which the ADI has recourse;
- Financial statements obtained by ADIs in circumstances for connected groups of SME borrowers are unlikely to provide for the necessary accounting consolidation and appropriate elimination of inter-company transfers, particularly where entities are not critical to assessment of serviceability or PD ratings as part of origination processes;
- APRA guidance does not accommodate scenarios where ADIs do not have recourse to entities connected to the borrower, and therefore do not recognise the broader revenue of the borrower group in assignment of PD and LGD ratings.
- Infrastructure (and similar) structures may be subject to 'ring fenced' revenues;
  - Lending at investor (not asset) level subject to various equity levels (for example investor owns 40% equity), whereby consideration of firm-size and large corporate measurement should consider revenue based on dividends, not the entire consolidated/aggregated group that have no direct relationship with serviceability assessment or PD assignment;
  - Where eligible for PD substitution (that is material risk transfer to an off-taker, eligible credit insurer or Export Credit Agency), use of guarantor revenue would be required within large corporate measurement. Consolidation of revenues to measure large corporate without connection to the underlying infrastructure project likely result in capital outcome disconnected with the underlying transaction structure.

Proposed industry approach

Given such challenges and operational limitations, the ABA proposes that the consolidated annual revenue of the entities to which an ADI has recourse should be utilised in determining asset class under APS 112 and APS 113, noting that this would align with the financial information utilised in the origination processes, including assignment of PD estimates.

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Appendix C: Removal of implicit government support from external rating of banks

Issue

APS 112 Attachment B page 13 states:

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

Following consultation with each of the ratings agencies (Fitch, S&P and Moody's), limitations associated with availability of data to meet the APS 112 requirement were identified.

Proposed industry approach

Industry proposes to use one or more of the approaches detailed below to calculate RWA for bank exposures.

Agency	Ratings available	Key points
Fitch	Shareholder Support Rating (**SSR**) Viability rating (**VR**) Note that individual default rating (**IDR**) and government support rating (**GSR**) are used in conjunction with the SSR and VR as part of the Fitch methodology.	• Data availability: Fitch published SSRs in November 2021 which incorporates shareholder/parent support but not sovereign support. The Fitch VR captures the banks standalone profile, or intrinsic creditworthiness. • Methodology: Fitch has determined that the Long-Term (**LT**) IDR of a bank can be attained based solely on its standalone financial strength (as reflected in its VR) or based solely on external support (as reflected in the SSR or GSR). It then assigns the IDR at the higher of these two levels. • Data coverage: SSR is not available for all banks. There is, however, broader coverage of VR • Different rating types available: VR is always LT. IDR has Short Term (**ST**) and LT ratings available. Local Currency and Foreign Currency are also available. • Senior debt and deposit ratings are also available (notched up from IDR), as are subordinated and hybrids (notched down from VR) • Fitch has indicated IDR is considered a regulated rating according to the European Securities and Markets Authority.
Moody's	XG rating Baseline Credit Assessment (**BCA**) and Adjusted BCA (considered a proxy rating)	• Data availability: Moody's are expecting to publish a new "XG" rating in 2022. BCA and adjusted BCA are currently available. • Methodology: The new XG rating leverages Moody's existing bank rating methodology. This is a 4 step process: (1) baseline credit assessment, (2) assessment of affiliate support resulting in in the adjusted BCA (3) loss given failure liability analysis (which results in a preliminary rating assessment) and (4) government support.

		• In the majority of cases the XG rating will be the same as the output of step 3. However, the current preliminary rating assessment (BCA rating) is not a published rating, it is an assessment. The XG rating will be more specific than the BCA rating, although sometimes it might be the same as the adjusted BCA rating. • Rating types available: The XG rating will be available at both LT, ST, foreign currency and local currency level. • Consideration of Loss Given Failure (**LGF**): Moody's issuer ratings are unique from the other agencies in that they consider a LGF assessment for each class of debt and deposits. The LGF assessment recognises that other creditors may rank ahead of the Bank's senior unsecured commitments depending on resolution regimes, that is, potentially resulting in downward notching.
S&P	Standalone credit profile (**SACP**) (considered a proxy rating)	• Definition: The SACP represents S&P's opinion of an issuer's creditworthiness in the absence of extraordinary intervention from its parent or affiliate or related government. It incorporates direct support already committed and the influence of ongoing interactions with the issuer's group and/or government. • It does not include potential future extraordinary support from a group or government, during a period of credit stress for the issuer, except if that support is system-wide. Neither does the SACP include the potential for the owner or government under stress to extract assets, capital, or liquidity from the issuer. • S&P do not consider SACP to be a rating in itself, rather a component of the issue or issuer credit rating. • As it removes multiple support types, adopting the SACP may be overly conservative.

Given the characteristics of each available ratings points, the ABA proposes that ADIs be allowed to use all options with the following logic (consistent with paragraph 6 of Attachment F of APS 112) to determine the final rating grade:

- If Moody's XG ratings are available to the ADI, use these (or equivalent ratings as developed by other agencies); or
- If Fitch SSR ratings are available to the ADI, use these.
- If neither are available, and standalone ratings by each of the rating agencies are available, use:
  - The lowest rating if two are available; or
  - The middle rating if three are available.

As standalone ratings contain no support, they are more conservative than the ratings which only exclude Government support. On this basis, they cannot be compared directly when determining which rating to use.

- If there are no standalone ratings available or ratings without government support, classify as unrated.

Appendix D: Inferred ratings for unrated exposures

Issue

APS 112 requires ADIs to utilise three approaches for inferring an external rating for unrated exposures such as bilateral loans (APS 112 – Attachment F – paragraph 5). This increases regulatory burden without improving prudential outcomes.

Proposed industry approach

The ABA proposes that ADIs may utilise any one, or combination, of the three specified approaches to inferring a rating for unrated exposures. Noting that ADIs will select between the three approaches based on ratings coverage and operational considerations.

The ABA does not expect that this assumption will have a material impact on the capital floor, an analysis of 28 Australian and New Zealand issuers with more than 15 issuances listed on Bloomberg identified that for each of the three ECAIs, there were no differences between the long-term foreign currency issuer ratings and senior unsecured issue ratings for each issuer.

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Appendix E: Standard vs non-standard loan categorisation

2.1: Mortgage Registration, Valuation and Documentation

The concept of a non-standard loan appears in APS 112 and carries over to APS 113 for retail residential mortgages.

APS 112 (Attachment A, paragraph 2-8) sets out requirements on mortgage registration, enforcement rights, documentation, valuation and serviceability that feed into standard/non-standard determination for property exposures. While some of these attributes may be available as atomic data elements for some periods of time, other requirements for example,

> *"All of the information... must be accurately documented and readily accessible..."*

are both broad in scope and do not lend themselves to specific data attributes. In such instances, reliance will have to be placed on business processes and controls which have varied significantly over time and will be different between ADIs. The documentation of a mortgage originated 20 years ago will look very different to one originated 2 months ago. Similarly, for older loans the documentation may not have been digitised and therefore the "readily accessible" part could be interpreted differently.

For other requirements, there will be issues associated with the historical capture of required data elements on bank systems. For example, with respect to mortgage registration, banks would find that although the mortgage is registered with the relevant Land Registry Office and the information is available on physical loan files/documentation, that information may not have been captured in a digitised form on bank systems nor in each Land Registry Office. For evidencing "appraised independently using prudently conservative criteria" for the back-book, it may not be possible to do much more than point to historical policies and processes.

A pragmatic implementation approach would make a distinction between a genuine credit determination of a non-standard loan versus an outcome impacted by data capture on legacy mortgage systems. It would also acknowledge that all the ADIs have been on a systems improvement pathway that has resulted in more robust business processes and controls over time.

To create consistency of approach between ADIs, the ABA recommends that APRA grandfathers the standard/non-standard loan conditions for the back-book for reasons mentioned above. For the front-book, it is reasonable to expect a system and process-based approach for a more rigorous and data driven demonstration of compliance against these rules.

2.2: Independently of any other mortgagee

The conditions on standard/non-standard loans covering second mortgages state (draft APS 112 Attachment A, page 9, paragraph 4c):

> "*the ADI, as second mortgagee, must be able to exercise its power of sale over the property independently of any other mortgagee over the property; and*"

The condition of exercising the power of sale "independently" is considered by legal counsel to be very strong. A simple example is if the first mortgagee refuses to attend the sale process, the second mortgagee could then proceed with the sale. In practical terms, the second mortgagee would always execute the sale through a consultative approach with the first mortgagee. The terms of these engagements are spelt out in the loan agreements and are consistent across the industry.

As it stands, the proposed wording will make all second mortgages where the first mortgage is held by another institution to fall into the non-standard category which, the ABA understands, is not APRA's intent with this clause.

Therefore, ABA wishes to notify APRA that the ADIs will not be putting all second mortgages into non-standard by default (as the wording implies) and will attempt to make a determination based on the spirit of the clause above.

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Appendix F: Interest only extensions

Issue

Customers who have had an interest only extension, where the cumulative term is > 5 years, must justify that they have had a servicing test undertaken after 5 years to be classified as a Standard loan.

Under existing prudential requirements not all interest-only servicing extensions are required to have full servicing assessment. Where an ADI determines that the risk of the customer is low and there are no material changes to the current or originally approved loan, an ADI is not required to complete a servicing assessment for an interest only extension.

Proposed industry approach

On this basis, industry proposes to grandfather loans that were approved under current prudential requirements but do not meet the definition of standard under the new APS 112 from 1 January 2023.

Appendix H: Daily Securities Financing Transaction Calculation

Issue

The current proposals would require securities financing transactions (**SFTs**) to be available daily and included in as an average in the leverage ratio. There is a considerable burden in generating daily calculations, while the average of daily exposures differs little from the average of month-end exposures.

Proposed industry approach

ADIs will calculate leverage ratios using average of month-end SFT exposures.

Reasoning

The current proposal would require ADIs to use the average of daily SFTs exposures for the calculation of the leverage ratio. Other components of leverage ratio are expected to stay at quarter-end observations. The average of daily exposures differs little from the average of month-end exposures.

Furthermore, calculating month-end exposures for SFTs is considerably less burdensome for ADIs. The ABA also notes that in the Australian context given the leverage ratio is not expected to be binding under APRA's framework.

As such, using the average of month-end SFT exposures in leverage ratio calculation provides a pragmatic balance between regulatory certainty and regulatory burden.