Australian Banking Association

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Australian Prudential Regulation Authority

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

Dear Mr Holland

APRA consultation: A more flexible and resilient capital framework for ADIs

The Australian Banking Association (**ABA**) welcomes the opportunity to provide our response to the Australian Prudential Regulation Authority (**APRA**) 2020 discussion paper on a more flexible and resilient capital framework for Authorised Deposit-taking Institutions (**ADIs**). The ABA also take this opportunity to thank APRA for participating in workshops with our members during the consultation period.

The ABA position

The ABA supports a capital framework that is resilient, flexible, comparable and transparent. We recognise the importance of stability in the Australian financial system and the role APRA's capital framework plays.

Throughout the COVID-19 global pandemic, ADIs have clearly demonstrated resilience and strength, acting as shock-absorbers by deferring repayments on nearly a million loans during 2020. The Australian economy is still recovering from the economic impacts of the COVID-19 pandemic and Australia's banks will have a vital role to play in this recovery by supporting customers and meeting the demand for competitively priced credit. The timing and nature of APRA's proposed changes to the capital framework will have an impact on banks during this critical period, and the ABA recommends that the final policy settings accurately reflect the proven resilience of banks and the needs of the Australian economy.

The ABA's full response to this consultation can be found in the attachment to this letter. In summary, the key issues are:

- **Calibration** - initial observations on the Quantitative Impact Study (**QIS**) suggest that revisions to the proposals will be required to achieve APRA's objectives for the capital framework. The ABA also expects further calibration to be undertaken to ensure there is no increase to the overall level of capital in the banking system above the "unquestionably strong" levels.
- **Non-standard treatment of interest-only mortgages** - the ABA considers that the proposed application of a non-standard treatment to interest-only mortgages with terms greater than five years is unduly punitive and does not reflect the enhanced servicing assessments for interest-only loans that have applied since 2015. Furthermore, the ABA considers that implementing a

non-standard treatment for these loans is unlikely to reduce the level of perceived risk within the ADI sector and will instead push interest-only lending to the non-ADI sector.

- **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 commensurate with the level of risk.
- **Capital buffers** – the ABA supports APRA's proposed increase to the baseline setting of the Counter Cyclical Buffer (**CCyB**) from its current default setting of zero. However, to maximise the flexibility within the revised capital framework, consideration should be given to increasing the default level of the proposed CCyB, with corresponding offset to the Capital Conservation Buffer (**CCB**).
- **Implementation timeframes** - the proposed new framework will involve significant changes to the existing capital regime. The revisions will require new IT systems and extensive updates to existing systems, policies, processes, and credit risk modelling, which makes the 1 January 2023 commencement date challenging. This will require the final prudential standards, guidance, and reporting standards to be finalised and published by 30 September 2020 if the 1 January 2023 commencement date is to be met. Like APRA, ADIs are eager to have the framework finalised and in effect, but want to ensure it is implemented effectively.
- **International comparability** - while the ABA appreciates APRA's greater alignment with the international Basel standards, the proposed APRA standards introduce new areas of divergence from these standards. This continues to impact Australian banks' ability to efficiently compete for funds on international markets. The ABA encourages APRA to promptly update its 2015 International capital comparison study to ensure there is, once again, authoritative clarity on the unquestionably strong capital position of Australian ADIs relative to their international peers.
- **Comparability and competition between the standardised and IRB approaches** - the proposed changes to the framework drive differences in definitions between standardised and IRB banks. Given the need for IRB banks to also report on a standardised basis, the different definitions may unnecessarily introduce complexity and comparability issues. In addition, in line with its objectives, APRA should ensure that the final capital framework revisions enable greater effective competition between standardised and IRB banks whilst continuing to meet financial stability and resilience objectives.
- **Pro-cyclicality of the capital framework** - given the lessons of COVID-19, the ABA considers that the proposed cyclical capital requirements could be altered and improved to strengthen existing industry resilience by increasing the ability of ADIs to use capital to absorb losses and to continue to lend during a stressed event. Some of APRA's current proposals may amplify volatility without necessarily improving the measurement of risk.

The ABA supports APRA's objective to maintain the overall level of capital in the system. We understand that APRA will consider the feedback alongside the results of the QIS and refine the draft proposals to ensure that the capital framework is appropriately calibrated to meet the "unquestionably strong" capital benchmarks.

The ABA welcomes APRA's extensive dialogue over this consultation period. Given the size of the changes involved and to assist the industry in meeting the 1 January 2023 deadline, the ABA supports the formation of an Implementation Taskforce by APRA, meeting monthly. The Taskforce comprising of APRA representatives and ADIs would work through the finalisation of the prudential standards, guidance and reporting standards towards an implementation of the revised capital framework on 1 January 2023.

Please contact me on essam.husaini@ausbanking.org.au or at 0419 884 148 if you have any questions.

Yours sincerely

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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.

Attachment – ABA feedback on APRA's consultation – A more flexible and resilient capital framework for ADIs

Introduction

The ABA appreciates the substantial efforts and guidance of APRA during the COVID-19 pandemic. Providing access to capital buffers and providing temporary relief on deferred loans under Prudential Standard APS 220 Credit Quality (**APS 220**) has allowed ADIs to support customers and the economy through this global pandemic. The support ADIs have provided to the economy is widely recognised as a key factor in reducing the economic impact of the crisis.

Throughout this pandemic, ADIs have demonstrated resilience and strength. This is in part a result of the work done by ADIs and APRA to date to ensure that ADIs are "unquestionably strong". Given this, the ABA welcomes APRA's objective to maintain "unquestionably strong" capital requirements.

APRA's finalisation of capital framework rules in 2021 will come at a time when the Australian economy is beginning to recover from the economic impacts of the COVID-19 pandemic. ADIs have an important role to play through this recovery by supporting customers and ensuring the ongoing flow of competitively priced credit into the economy. Any restrictions or increases in specific capital requirements could have a material economic impact on the recovery. In finalising the revisions to the capital framework in Australia, we ask APRA to consider the overall impact and timing of these changes to ensure they do not hinder the ability of ADIs to support the Australian economy in its recovery from the pandemic. This is particularly true for small business customers who have been most impacted by the pandemic.

The ABA's submission on APRA's capital framework is organised as follows:

- Key concerns
- Prudential Standard APS 110 Capital Adequacy (**APS 110**) specific issues
- Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk (**APS 113**) specific issues
- Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (**APS 112**) specific issues
- Issues relevant to both APS 112 and 113
- Consistency between standards
- Related prudential standards
- Other issues

Key concerns

Calibration

As previously stated, the ABA supports the principle that any reduction in RWA is matched by an increase in regulatory buffers to ensure minimal change in the "unquestionably strong" capital levels (in nominal terms).

However, there are a number of calibration issues that we ask APRA to consider when finalising the framework. These include:

- <u>Lower than expected risk weighted asset (**RWA**) reduction</u>: The ABA considers that changes from APRA's proposals (including flagged further changes to Prudential Standard APS 115 Standardised Measurement Approach to Operational Risk) would not align with the expectation of approximately a 10 per cent decline for IRB ADIs or approximately 7 per cent for standardised banks as per the APRA proposal policy papers[1]. The ABA encourages APRA to consider our recommendations on changes to credit risk as outlined in this submission to bring the outcomes closer to the expectation of 10 per cent reduction.

- Recalibration of capital buffers: Alternatively, a reduction to the proposed increase in the CCB of 1.5 per cent and Counter cyclical buffer CCyB of 1 per cent is recommended to accommodate a lower-than-expected decline in RWA. To the extent that this is the case, the ABA's recommendation to APRA is to keep the CCB at the same level as today and recalibrate via the CCyB. This would imply an increase in the CCyB of 1 - 2.5 per cent as further discussed in the Capital Buffers section of this submission.
- Impact of non-credit RWA changes: There are a number of reforms to the prudential framework that have already been implemented, e.g. standardised approach to measuring counterparty credit risk (**SA CCR**); some not yet been implemented, e.g. APS 115 Standardised Measurement Approach to Operational Risk (**APS 115**); others that are still under consultation, e.g. APS 117 Interest Rate in the Banking Book (**APS 117**) and APS 116 Market Risk (**APS 116**). Some standards will not be finalised until closer to 2023 or later (e.g. APS 116). Whilst the QIS requires ADIs to provide their best estimate of the impacts, APRA will need to consider the capital impacts of changes to these numerous prudential standards prior to any decision on capital buffer calibration. This is especially the case with impacts arising from potential changes to APS 116 which is not captured as part of the QIS.
- Appropriate calibration of Level 1 and Level 2 capital: The ABA understands that APRA will use the results of the QIS to calibrate the framework to ensure that changes do not result in any additional increase to overall capital requirements[2]. This calibration needs to consider both Level 1 and Level 2 impacts on capital, as APRA's changes are different on both levels due to the treatment of equity deductions and the use of RBNZ requirements for Level 2 capital. The ABA is concerned that if the calibration were to focus on the domestic level only (Level 1), it could result in a Level 2 capital position that is above the existing "unquestionably strong" capital requirements for the system. The ABA recommends an appropriate calibration of both Level 1 and Level 2 capital buffers to ensure that the objective of no net increase in capital levels is achieved.

Recommendation – the ABA recommends the following:

- APRA review and amend the key proposals in APS 113 and APS 112 (e.g. treatment of non-standard mortgages and New Zealand exposures) to achieve a reduction in RWA consistent with maintaining the nominal amount of capital the same or recalibrate the increase in capital buffers accordingly, primarily via a reduction in the proposed increase in CCB of 1.5 per cent. Any changes to APS 113 will need to be considered alongside the impacts of the application of the standardised floor of 72.5 per cent.
- That recalibration of capital buffers take into account potential impacts from the finalisation of changes to the non-credit RWA requirements (APS 115, APS 116 and APS 117) as well as the introduction of 1.5 per cent CCyB by the RBNZ.
- That APRA retains the flexibility for appropriate calibration of capital buffers between Level 1 and Level 2, should the variation in the RWA changes become material.

[1] APRA's Discussion Paper: A more flexible and resilient capital framework for ADIs, December 2020, page 19.
[2] APRA's Discussion Paper: A more flexible and resilient capital framework for ADIs, December 2020, page 15.

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Non-standard loans for mortgages

Interest-only loans

APRA is proposing that interest-only loans with interest-only periods of greater than five years cumulatively, be classified as 'non-standard' loans[3]. APRA is proposing that the application of a non-standard treatment is an appropriate reflection of the inherent risks with these types of loans. APRA has noted that it does not expect the non-standard treatment of these loans to have a material impact on the residential mortgage portfolio of ADIs

The ABA does not support this proposal. The proposed treatment of interest-only loans with an interest-only term of greater than five years as non-standard suggests that long tenured interest-only loans represent up to four times the risk of a standard mortgage[4]. Further, APRA's proposed treatment does not seem to take into consideration the reduced risk from lenders mortgage insurance (**LMI**) held against interest-only mortgages. As a result, the proposed treatment of these mortgages will be 25 per cent higher than unsecured retail credit card exposures. The ABA does not consider that the treatment is commensurate with the risk.

This excessive capital charge will also have impacts on other aspects of the capital framework. It will, among other things, affect the risk-weighting of securitisation exposures under the Supervisory Formula Approach in Prudential Standard APS 120 Securitisation (**APS 120**).

The proposed non-standard treatment of interest-only mortgages occurs in combination with other more punitive treatments under the capital framework. These include:

- Interest-only loans being subject to higher risk weights than owner occupied principal and interest loans under APS 112; and
- The application of a higher scalar under APS 113.

In addition, mortgages will still need to be assessed as standard or non-standard under the requirements set out in paragraphs 3 to 7 Attachment A of the draft APS 112.

Since 2015, banks are more accurately measuring the credit quality of interest-only mortgages by undertaking enhanced servicing assessments for these loans, tightening the criteria by which a customer can obtain an interest-only extension and limiting the extension period[5]. In addition, any further extension of an interest-only period sought by a borrower is subject to a full servicing assessment[6]. These processes have improved the assessment of risk, and this is reflected in banks' arrears data collected by APRA[7].

Interest-only mortgages are an attractive product for investors who want to benefit from negative gearing tax treatment. Limiting interest-only mortgages to less than five years or by applying punitive capital treatments (and associated pricing) for loans greater than five years will likely lead customers to switch lenders once the five-year interest-only term is complete. While a borrower would be subject to a full serviceability assessment at another ADI, it is unlikely to be treated as a non-standard mortgage. Whereas, if the borrower is reassessed by their existing ADI, it would be classified as a non-standard mortgage. The higher cost of a non-standard mortgage will increase churn, and will not effectively reduce risk across the industry. Furthermore, given the capital increases will not be required for non-ADI lenders, interest-only lending may be directed to the lightly regulated non-ADI sector.

[3] APRA response to submissions, "A more flexible and resilient capital framework for ADIs", December 2020. https://www.apra.gov.au/sites/default/files/2020-12/Response%20to%20submissions%20paper%20-%20A%20more%20flexible%20and%20resilient%20capital%20framework%20for%20ADIs.pdf.
[4] Draft Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk, paragraph 19(a) of Attachment A.
[5] APRA letter to all ADIs, Consultation on revisions to Prudential Practice Guide APG 223 Residential Mortgage Lending, (21 May 2019) https://www.apra.gov.au/sites/default/files/letter_consultation_on_revisions_to_prudential_practice_guide_apg_223_residential_mortgage_lending.pdf.
[6] APRA Prudential Practice Guide, APG 223 Residential Mortgage Lending, July 2019, https://www.apra.gov.au/sites/default/files/apg-223-residential-mortgage-lending_0.pdf.
[7] APRA Information Paper, Review of APRA's prudential measures for residential mortgage lending risks, 29 January 2019, https://www.apra.gov.au/sites/default/files/review_of_apras_prudential_measures_for_residential_mortgage_lending_risks_-_january_2019.pdf.

The ABA does not consider that an assessment of the aggregate / cumulative interest-only period of loans is necessary given:

- Since 2015, a full serviceability assessment is generally undertaken for all new interest-only loan renewals or extensions, so simply aggregating the interest-only periods does not take into account credit assessments undertaken during the aggregate period, nor any repayments of principal that have occurred during the aggregate period;
- Simply looking at the aggregate period of interest-only periods does not take into account temporary changes in circumstances surrounding the interest-only periods, for example when borrowers have a temporary change in income e.g. parental leave; and
- From an operational perspective, it will be difficult for banks to track the aggregate interest-only period of a loan. Historical data may be limited and not easily tracked back to the point of loan origination. Tracking clients over extended periods which could include several significant principle and interest periods, and may span interest-only splitting and subsequent account amalgamation, is challenging.

Recommendation – the ABA proposes that draft APS 112 paragraph 19(a) of Attachment A be removed. Interest-only loans with a cumulative interest-only term of greater than five years should not be automatically classified as non-standard given the enhanced lending standards in place since 2015, other non-standard criteria now being introduced, and the potential impacts to customers.

In the event APRA decides not to remove draft APS 112 paragraph 19(a) of Attachment A, we recommend that APRA narrow the definition of non-standard loans and consider applying the non-standard classification to interest-only loans which have a single term of more than five years, recognising that any extensions or renewals will be subject to a full serviceability assessment.

Equity line of credit products

Under the current proposal, the ABA notes that equity line of credit products could be interpreted as being interest-only products. As a result, these products (which typically have terms of greater than five years) would incur a non-standard treatment under the draft APS 112. The ABA is of the view that these equity line of credit products are of lower risk and have historically lower losses[8], and do not consider a non-standard treatment for these products as appropriate.

Recommendation – the ABA recommends that APRA exclude equity line of credit products from the definition of non-standard. We note that APRA removed these types of products when it applied an interest-only cap limit in 2017[9].

RBNZ capital reforms

As currently proposed by APRA, the RBNZ capital reforms will affect the capital position of ADIs by:

- Incorporating the application of the RBNZ CCyB of 1.5 per cent, applied on New Zealand private sector exposures at both Level 1 and Level 2; and
- Calculating credit RWA for New Zealand exposures as per RBNZ requirements – the ABA understands that it is APRA's expectation that this includes the application of the 1.2 scalar and 85 per cent output floor.

The combination of the above will result in capital allocation to New Zealand exposures at Level 2 that is unduly conservative as APRA have selectively adopted features of the RBNZ capital framework which have been calibrated to a higher level that the RBNZ believes is more suited for the New Zealand banking system.

[8] Specific data on this is included in ABA member banks' individual submissions.
[9] APRA letter to ADIs, "Further measures to reinforce sound residential mortgage lending practices", March 2017, https://www.apra.gov.au/sites/default/files/Further-measures-to-reinforce-sound-residential-mortgage-lending-practices.pdf.

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 APRA's "unquestionably strong" requirements.

Recommendation – the ABA recommends the following approach:

- APRA reconsiders its approach in adopting the RBNZ capital requirements at Level 2. At the minimum, the ABA considers that the application of the 1.2 scalar and 85 per cent floor should be removed from the credit RWA requirements.

Capital buffers

The ABA supports APRA's stated objective to maintain ADIs capital levels at the unquestionably strong benchmark levels, with any potential changes to RWA, as a result of the capital reforms, to be calibrated through changes to capital buffers. The ABA understands that on the basis of a 10 per cent RWA reduction for IRB ADIs, APRA has proposed increasing the CCB by 1.5 per cent and introducing a default non-zero CCyB at 1 per cent for greater flexibility.

However, the ABA recommends APRA consider maximising the flexibility of the capital framework by calibrating any potential reduction in RWA via the CCyB only and leaving the CCB at the current 3.5 per cent level for domestically significant banks (**D-SIBs**) or 2.5 per cent for other ADIs. This would imply an increase in the size of the proposed default non-zero CCyB from 1 per cent up to 2.5 per cent. As a result, it could lead to an increase in the CCyB of up to 1.5 per cent compared to APRA's proposal with corresponding reductions to the proposed CCB requirements. This will equip APRA with a larger and more effective regulatory tool which increases flexibility to reduce regulatory buffers depending on the severity of stress. Further, this flexibility would not risk prudential safety of the banking system and ensures ADI capital levels continue to meet the "unquestionably strong" benchmark under normal operating conditions as APRA retain the ultimate discretion in setting the level of CCyB for Australia. To avoid an increase in capital required for standardised ADIs beyond "unquestionably strong" levels the ABA does not propose any increase in the total of the CCB and CCyB for these banks (CCyB differences between standardised and IRB banks are discussed further below).

International experience

The ABA notes that some Basel jurisdictions (such as Hong Kong, Norway, Sweden and Denmark) that were operating with positive levels of CCyB prior to the COVID-19 pandemic, have reduced their CCyB in response to the economic stress and that such reduction to the CCyB has been widely accepted to be effective in supporting lending capacity and maintaining confidence level in banks. Recent modelling by the European Central Bank indicated that in stressed scenarios, a broad-based use of available capital buffers could increase lending to the real economy by more than three per cent, and GDP by over 0.5 per cent[10]. Although it is not practical that all regulatory buffers are released to support lending, the findings do support the ABA recommendation that having a higher proportion of more flexible buffers that could be reduced in appropriate circumstances enhances the ability for banks to support domestic lending growth in times of stress.

Conversely, the ABA considers that the CCB has not operated as effectively as intended in Australia during the COVID-19 pandemic, despite the regulatory framework allowing banks to access the CCB under stress. Generally, banks were reluctant to use the buffer and there are two key reasons for this:

- The impact of regulatory restrictions on distributions (in particular on Additional Tier 1 securities distributions) associated with the use of the buffer; and

[10] European Central Bank, "Buffer use and lending impact" https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202010_2~400e8324f1.en.html.

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- An ADI dipping into the CCB, would have likely been viewed negatively by market analysts and investors (despite the unquestionably strong capital levels), leading to potential difficulties for ADIs in attracting new capital if required[11].

To avoid such an adverse outcome, ADIs will in the first instance, naturally protect their capital levels by avoiding reductions to regulatory buffers. This could result in a tightening of risk appetite and reduction in lending to conserve capital during periods of economic stress.

Use of capital buffers during the COVID-19 pandemic

Whilst not required during COVID-19, ADIs (and the market) arguably had reservations in the actual ability to utilise buffers if the stress conditions had deteriorated further. This is evidenced by the IRB banks increasing their Common Equity Tier 1 (**CET1**) capitalisation levels by 125 basis points (**bps**) on average or $22.5 billion in aggregate CET1 capital equivalent in the nine months from March 2020 up to December 2020. This occurrence was despite APRA's announcement in March 2020 that there would be no concerns by APRA if ADIs were not meeting the unquestionably strong benchmarks. Increases to CET1 capitalisation levels were also made by the five largest standardised banks in Australia, resulting in an average CET1 ratio increase of 50bps. The ABA considers that more clarity in regard to the approach to be taken by regulators in the event that capital targets or regulatory buffers are reduced, and the regulatory approach to restoration of such buffers post stress, is needed. Otherwise, the ABA considers it is likely that banks will remain hesitant to utilise such buffers as intended in future[12].

The ABA considers that one of the key learnings globally from the COVID-19 pandemic will be the benefit of trading off part of the current CCB for higher CCyB in the near future. The ABA considers that the current review of the capital framework is an opportunity for APRA to consider the merit of this idea and to be 'ahead of the curve' in implementing a capital buffer framework that will be more practical in times of financial stress.

CCyB differences between standardised and IRB approaches

The ABA acknowledge that APRA may be concerned about a differentiation in the default setting of CCyB between an IRB ADI and standardised ADI. The ABA does not believe this concern is warranted and that the added complexity from differing CCyB should be manageable. At present, APRA already manage ADIs with varying unquestionably strong targets, CCB requirements (e.g. between D-SIB and non-DSIB). The prudential benefits from increased flexibility to the system should out-weigh any complexity from the difference between IRB and standardised ADIs in the capital framework.

Additionally, the ABA considers that differing CCyB between IRB and standardised ADIs is appropriate, given the higher levels of pro-cyclicality in RWA, which is more prevalent in IRB modelling. The experience from COVID-19 stress has shown the potential for credit risk migration to materially reduce reported capital ratios of IRB ADIs. This reduction, however, is largely temporary as the majority of the impacts from credit migration will unwind over time. Nevertheless, the adverse effects from having to potentially report headline capital ratios that are below market expectations, even for a short period of time, may force ADIs to conserve capital, including potentially reducing lending to some parts of the economy in order offset the impacts of higher credit RWA from risk migration. The ABA considers that this outcome does not support economic recovery, while a larger CCyB component would. This is because it provides regulators with the option of additional temporary capital buffer relief for IRB ADIs, which can be progressively increased as credit migration unwinds post stress.

Revisions to the indicator framework

The ABA understands that APRA intends to revise the indicator framework that sets out the operation of the CCyB, including articulating APRA's expectation for when the CCyB will increase or decrease from its default setting. To enhance certainty and confidence, the ABA considers that the guidance should be specific and ideally include triggers that make reference to macro-economic data or the core

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[11] Reserve Bank of Australia, "Different Approaches to Implementing a Countercyclical Capital Buffer", September 2020 Bulletin, https://www.rba.gov.au/publications/bulletin/2020/sep/different-approaches-to-implementing-a-countercyclical-capital-buffer.html#fn0.
[12] As per footnote 11.

indicators that APRA monitors as part of the current CCyB framework[13]. The triggers should not only inform when the CCyB level should be reviewed, but the likely amount that the CCyB could be changed by. The guidance should also provide certainty as to the timing for recapitalisation of buffers post stress, 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 banks' appetite to continue lending during an economic recovery. The ABA would welcome the opportunity to work with APRA to develop the final guidance should APRA agree that this is appropriate.

Recommendation: the ABA recommends that APRA increase the proposed CCyB, with corresponding offset to the CCB. The recalibration of the impacts from potential reduction in RWA should be done by adjusting the level of default non-zero CCyB requirement only, with no change in the CCB requirements from current levels.

In addition, the CCyB guidance should include triggers that should inform the timing and quantum of potential CCyB change. The guidance should emphasise that the rebuild of capital buffers should be orderly and this includes an appropriate timeframe for buffer rebuild that is commensurate to the amount reduction. For example, providing 12 months to rebuild every 25bps in CCyB.

Implementation timeframes

The ABA notes APRA's intention for the revised capital standards to commence operation on 1 January 2023, and that APRA plans to finalise and release the standards at the end of 2021. The ABA is concerned that the proposed implementation timeline is not adequate to make the required changes under the new draft standards, and related standards (e.g. Prudential Standard APS 210 Liquidity (**APS 210**)). ADIs will need to make extensive updates to systems, policies, processes, and credit risk modelling that would make the 1 January 2023 commencement date challenging. In addition, IRB banks have additional requirements relating to the introduction of the standardised capital floor, and associated data and infrastructure changes. Furthermore, there will be impacts to customers which will need to be worked through as they arise from capital allocation shifts amongst segments and products.

The implementation of the revised capital standards also occurs at the same time as other significant regulatory projects. These include:

- The Financial Accountability Regime (**FAR**);
- Risk Management standards (Prudential Standard CPS 220 Risk Management and APS Prudential Standard APS 220 Credit Risk Management); and
- Prudential Standard APS 330 Public Disclosure.

At a minimum, for some ADIs, the standards would need to be finalised and published by 30 September 2021 for them to meet the proposed commencement date. ADIs are unable to begin making changes to IT systems, internal policies, and processes until the final standards are released. To assist with meeting the implementation timeline, the ABA requests continued engagement with APRA as the draft standards are progressed and suggest monthly implementation workshops.

The ABA also notes that material changes to the relevant reporting standards are likely to be needed as part of the finalisation of the revisions to the capital framework. Given this, the ABA seeks clarity on the timing and nature of the release of these reporting standards, including whether they will follow a similar data set process to Reporting Standard ARS 220 Credit Risk Management. A significant delay in release of the reporting requirements will impact the ability of ADIs to meet the proposed commencement date.

Recommendation – the ABA supports continued engagement with APRA on its timelines for implementation and request ongoing monthly implementation workshops over the next 24 months. We seek clarification from APRA on a proposed timeline for release of standards, prudential practice guides

[13] APRA Information Paper: The countercyclical capital buffer in Australia, December 2015 https://www.apra.gov.au/sites/default/files/151217-CCyB-Information-Paper_FINAL.pdf.

and reporting requirements such that ADIs can efficiently plan resource requirements to ensure meeting then proposed implementation date of 1 January 2023.

International comparability

The ABA welcomes APRA's revisions to the proposed capital framework that further align the Australian prudential framework with that of the international Basel framework. Where APRA applies national discretion to diverge from the international framework, the ABA recommends that these are made transparent and comparable.

The ABA questions the need for super-equivalence to the Basel standards given the proven strength and resilience of Australian ADIs who now have much higher levels of capital, more liquid assets, and more stable funding structures. As outlined in the ABA submission[14] to APRA's 2019 consultation, global comparability is critical for Australian banks as they compete for funding on global markets. As far as practicable, Australian banks should be competing on a level playing field, in both domestic and international financial markets.

The ABA notes that APRA's current proposals contains several settings which remain inconsistent with Basel and introduce new areas of divergence from the international framework. Such divergence arises in the following areas:

- Treatment of deductions where APRA currently takes a more conservative approach;
- Retail exposures definition of higher risk mortgages, specific scalars for higher risk mortgages and non-standard treatments;
- Higher risk weights for standardised mortgages than Basel equivalents where loan to value ratios are 70 per cent plus for all categories, including owner occupied principal and interest loans;
- Loss given Defaults (**LGD**) under the Foundation Internal Ratings-based (**FIRB**) approach for unsecured senior exposures and exposures secured with physical collateral;
- Adoption of RBNZ capital rules for New Zealand exposures; and
- The IRB scaling factor of 1.1.

Australian banks face competition from global peers who are not bound by the higher standards proposed by APRA. Higher APRA requirements on Australian banks will mean they are at a distinct competitive disadvantage to those banks regulated by jurisdictions that adopt the Basel standards. APRA's super-equivalence to the Basel standards effectively creates a regulatory barrier to entry and expansion for domestic banks to compete in international financial markets in areas such as institutional banking asset finance.

Recommendation – the ABA is strongly supportive of aligning the APRA standards to the Basel international standards:

- It is recommended that consideration is given to a standardised APRA mandated methodology to (a) reconcile any divergence from the Basel framework; and (b) highlight areas where national discretion has been applied.
- The ABA encourages APRA to update its 2015 International capital comparison study to ensure there is, once again, authoritative clarity on the unquestionably strong capital position of Australian ADIs relative to their international peers. This should include APRA's existing areas of divergence (for example, the deduction approach for equity investments and deferred tax assets, and the inclusion of IRRBB as a Pillar 1 requirement). Any new divergence should also be included, for example, the retention and increase of the IRB scaling factor to 1.1 and the higher FIRB LGDs if this is retained.

[14] ABA submission, "Submission on APRA's revisions to the capital framework for ADIs", September 2019, https://www.apra.gov.au/sites/default/files/2020-12/ABA%20-%20non-confidential%20submission-%20September%202019.pdf.

- As disclosures on the standardised approach will likely be used as a point of reference across banks internationally, the methodology should similarly highlight areas of divergence and national discretion in the standardised framework – for example, the proposed segmentation by loan purpose for residential mortgage exposures.

Comparability and competition between standardised and IRB ADIs

The ABA is supportive of APRA's proposed changes which provide for more comparable approaches between standardised and IRB ADIs. This includes reducing differences in capital outcomes between the two approaches i.e. for commercial property, SME lending, and the non-retail credit conversion factors (**CCF**). However, a number of APRA's changes are driving inconsistencies between the two approaches which make the differences less transparent, more difficult to compare outcomes and increase complexity in implementation.

In addition, in line with its objectives, APRA should ensure that the final capital framework revisions enable effective competition between standardised and IRB banks whilst continuing to meet APRA's financial stability and resilience objectives.

The ABA welcome the additional risk weight category proposed under the standardised approach for those mortgages with a 60-70 per cent loan-to-value ratio (**LVR**). This recognises the lower risk for this category of mortgage and aligns with the Basel standards[15]. However, given the application of capital buffers for standardised banks in line with IRB banks, the ABA would welcome clarity on the rationale for APRA's proposed divergence from the Basel standards where imposts of 5,10 and 20 per cent are applied to risk weights for standardised mortgages on owner occupier principal and interest paying mortgages for segments 70 to 80 per cent LVR, 80 to 90 per cent LVR and greater than 90 per cent LVR.

Differentials between the Basel treatment of standardised home loan risk weights and APRA's standardised weights are more pronounced for investor and interest-only loans than that also considered for lower risk mortgage lending. Where APRA seeks to not fully recognise LMI within risk weightings for mortgages where the LVR is greater than 80 per cent, the application of add-ons to standardised mortgages under 80 per cent LVR to the Basel standard puts standardised banks at a disadvantage.

The ABA suggests that APRA consider addressing any concern for concentration risk or other ADI specific risk factors through adjustments to CCB and CCyB. This allows for adjustments on a case by case basis rather than setting add-ons to Basel's standardised risk weighting measures.

Recommendation - the ABA recommends that APRA consider greater alignment across the IRB and standardised approaches, minimising differences where possible. In finalising the revisions to capital framework, APRA should consider the overall framework to ensure that it enhances competition between standardised and IRB banks while continuing to meet financial stability objectives.

In addition, ABA would welcome clarity from APRA in regard to its rationale for the proposed divergence from the Basel standard for standardised approach mortgage risk weights.

[15] https://www.bis.org/basel_framework/chapter/CRE/20.htm?inforce=20230101&published=20201126.

APS 110 Capital Adequacy - specific issues

Capital distribution constraint

APRA's proposed changes to increase the CCB by 2.5 per cent (of which 1 per cent is in the form of the CCyB) would materially reduce the size of the current management buffer to the top of the CCB (as this will be increasing from 8 per cent to 10.5 per cent). The impact from a reduction in the management buffer to the top of the CCB may be perceived as additional risk by Additional Tier 1 (**AT1**) investors and may adversely affect the ability to raise AT1 capital. This is acknowledged by the RBNZ as part of the capital review changes, and has led to the RBNZ adopting a separate set of restrictions for AT1 distribution, whereby AT1 distribution payments will only be restricted at a lower point in the RBNZ Prudential Capital Buffer relative to ordinary share dividends or bonuses.

The significant reduction in CET1 buffer to the top of the proposed higher CCB requirements is sub-optimal to the ADIs' ability to raise AT1 capital and may lead to investors' perception of increased risk for ADI's AT1 distribution payment which may be exacerbated under a severe stress event.

Recommendation - as aggregate AT1 distribution is relatively immaterial to ADI's capital base (not more than approximately 6 basis points (**bps**) per annum), the ABA recommends that APRA consider adopting a lower CET1 threshold for AT1 distribution to be restricted, whilst ordinary share dividends and discretionary bonus payments remain restricted once CET1 is below the top of the CCB. An example of this is for AT1 distribution to remain unrestricted until CET1 ratio breaches the first quartile of the CCB (e.g. CET1 ratio 6 per cent or 5.75 per cent if CCyB is set to 0 per cent assuming APRA proposed buffer requirements), in which case all common equity distributions will be set to nil. At the minimum, the CCyB component should be excluded when assessing CCB distribution restrictions

Total Loss Absorbing Capacity (TLAC)

The ABA supports a finalised approach that does not make changes to TLAC and considers that the current TLAC requirements are adequate to facilitate the orderly resolution of Australian ADIs and minimise the impact on taxpayers.

The ABA understands that APRA is intending to release a new standard to improve resolution capability, implement reforms from the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* and set out requirements for the development and execution of recovery and resolution plans[16]. The ABA would not support any increase in TLAC as part of APRA's development of this new resolution capability policy and supports APRA prioritising the finalisation of the capital framework. The ABA do not believe that additional costs for customers associated with an increase in TLAC levels would have a material impact on reducing the risk within the banking system in Australia.

Recommendation – the ABA does not support increasing TLAC, and we would recommend APRA maintains TLAC at its current levels.

Capital floor

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 (noting that for certain assets classes or risk types, there are common approaches for both IRB and standardised ADIs)[17].

The ABA notes that the prevalence of super-equivalent capital deductions under APRA's capital framework leads to the potential for this super-equivalence to flow through to the calculation of the standardised capital floor as well, unless adjusted for.

[16] APRA's Policy Priorities, https://www.apra.gov.au/apras-policy-priorities (accessed 31 March 2021).
[17] 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.

For an illustration of this, consider an ADI with $100 billion of RWAs under the standardised approaches and $75 billion RWAs under IRB approaches:

- Applying the Basel rules, the ratio of RWAs under IRB approaches to RWAs under standardised approaches would be 75 per cent.
- Under the APRA rules, the super-equivalence introduced in relation to deductions means that exposures that are RWAs under Basel rules, such as equity investments, deferred tax assets (**DTAs**) and capitalised expenses, are treated as deductions under APRA rules instead.

Continuing with the illustration, if this were to lead to a $10 million reduction in RWAs, RWAs as calculated for a standardised bank would reduce to $90 million whilst RWAs as calculated for an IRB bank would reduce to $70 million. As such, the IRB to standardised ratio would, therefore, reduce to 72.2 per cent, meaning that 72.5 per cent capital floor would be binding as a result. This is illustrated in the table below:

Illustrative example	Basel		APRA's proposal		ABA's recommendation	
$Ab	Standardised bank	IRB bank	Standardised bank	IRB bank	Standardised bank	IRB bank
Total RWAs	100	75	90	65	90	65
Add super-equivalent deductions converted to RWAs[18]	n/a	n/a	n/a	n/a	10	10
Total RWAs (adjusted)	**100**	**75**	**90**	**65**	**100**	**75**
IRB to standardised ratio (72.5% floor)	**75.0% (not binding)**		**72.2% (binding)**		**75.0% (not binding)**	

This super-equivalence could be accounted for by either:

- Lowering the calibration of the capital floor to account for this effect, although noting that this would vary from bank to bank depending on the quantum of deductions; or
- Adjusting the calculation of the capital floor to increase 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. into RWAs)[19].

Recommendation - the ABA recommends that the calculation of the standardised capital floor takes into account APRA's national-specific deductions, through one of the two approaches outlined above. Furthermore, the implications of APRA's proposed changes to the treatment of ADI's equity investment in banking and insurance subsidiaries under APRA's revisions to Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (**APS 111**) would result in significant reduction in Level 1 RWA (albeit overall capital requirements may not reduce given the application of capital deduction treatment for equity investments above the 10 per cent Level 1 CET1 threshold). This in combination with the proposed changes to APS 113 would also further increase risk of the ADI being bound by the capital floor at Level 1. Therefore, similar to the recommendations above, the ABA propose that capital deductions for equity investments above the 10 per cent CET1 threshold be considered when assessing Total IRB RWA against the 72.5 per cent capital floor.

[18] Super-equivalent deductions would be converted to RWAs via the following calculation: Additional RWAs = National-specific deductions/10.5 per cent for D-SIB ADIs or 9.5 per cent for IRB ADIs.
[19] 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.

APS 113 Internal Ratings-based Approach to Credit Risk - specific issues

SME retail exposures

Threshold of SME retail exposures

The ABA notes APRA's intention to increase the eligibility threshold for the SME retail treatment from $1 million to $1.5 million in aggregate exposure, in line with updates to the foreign currency thresholds in other parts of the proposed standards.

While the ABA welcomes this increase, consideration should be given to setting a higher threshold that appropriately reflects the contemporary nature of this segment in Australia and is consistent with the prevailing definition of small business that is applied today under the ABA's Banking Code of Practice.

The application of a higher threshold would make SME lending more capital efficient and could increase its supply to the economy. SMEs are a key driver of economic growth in Australia and applying a higher threshold would encourage greater investment in this segment of the population, which is of particular importance as the economy recovers from the pandemic.

Recommendation – the ABA recommends that APRA align the SME retail exposure threshold to a higher dollar amount that reflects underlying portfolio risk characteristics and the Australian regulatory environment. The ABA would recommend it be increased to an amount in the range of $3 million - $5 million[20], which we consider is appropriate for the risk level and takes into consideration the alignment of current (and future) thresholds definitions of small business applied in the ABA's Banking Code of Practice.

SME annual revenue threshold

The ABA notes that APRA is proposing to impose a new ADI requirement to test on a yearly basis its SME exposures threshold against an annual revenue threshold. This would result in the ADI being required to obtain financials every year from small business customers. For the SME retail segment in particular, these exposures are pool managed and not relationship managed imposing such a requirement to assess revenue would be costly operationally difficult for the industry to apply.

APRA's requirements state that the annual revenue threshold would need to come from audited consolidated financial statements. SME customers typically do not produce audited and / or consolidated financial statements as required by APRA. Should APRA adopt this proposal this would result in ADIs requiring annual consolidated and audited financials accounts from small business customers, which is a significant impost for these customers. In some instances where this data cannot be captured, the likely higher RW treatment that would result may impact the ability of ADIs to lend to these SMEs.

APRA has adopted the Basel risk weights applicable for SME corporate (85 per cent) and SME retail (75 per cent), but the ABA note that Basel does not require the capture of annual financial data for retail SME. Under paragraph 43, Basel only requires the capture of annual sales data for corporate SME but this requirement does not extend to the retail SME exposures which are assessed under paragraph 55.

Recommendation - the ABA recommends APRA amend its qualifying criteria for a SME retail borrower to exclude the need to capture annual revenue. This would align with the approach set out in Basel.

Scalars and risk weights for defaulted assets

The ABA notes that APRA is proposing to introduce RWA scalars or higher RW for defaulted assets in the following portfolios:

- Residential mortgages
- Commercial property

[20] APRA should refer to individual bank submissions on credit risk portfolio modelling undertaken for this cohort.

These scalars would be consistent with those used to calculate capital for non-defaulted assets. However, the RWs for defaulted residential mortgages are higher than those for non-defaulted assets.

The ABA notes that the capital calculations for defaulted assets are different to those for non-defaulted assets. For defaulted assets under APS 113, the methodology takes the difference between the downturn / stressed loss given default (**LGD**) and the 'best estimate of expected loss' (**BEEL**). This approach considers that the risk in a defaulted asset is no longer that the client defaults but that the realised losses could be higher than current BEEL. Hence capital is held for the gap. This is already a conservative measure using the downturn LGD to measure worst cases losses and the risk weighted asset equivalent of this capital amount is typically quite high.

Additionally, for defaulted assets under APS 112 there appears no obvious rationale for increased RWs, when compared with the current standards.

Applying higher RWs or adding a scalar on top of the calculation of defaulted RWA further increases the conservatism in the RWA calculations which does not reflect the actual risk of further loss in these assets. In addition, the application of the scalars or higher RWs would exacerbate procyclicality of RWA in times of stress. Due to the application of these scalars or higher RWs, as more customers default in these already large commercial property and residential mortgage portfolios, the RWA requirements will increase beyond banks' current stress tests.

Recommendation – the ABA recommends that under APS 113 APRA removes the RWA scalars on defaulted assets to align with Basel, given that downturn LGD has recognised such heightened risk in the expected loss calculation, and under APS 112 aligns the RWs for defaulted mortgages to those for non-defaulted assets.

Sovereign LGD

APRA is proposing that all sovereign exposures will be subject to the Foundation Internal Ratings-based (**FIRB**) approach, with supervisory LGD estimates. This includes a five per cent LGD for sovereigns rated AA- or better (Standard & Poor's equivalent) and 50 per cent LGD for all other sovereigns. The ABA has concerns that this proposal will have the consequence of introducing a "cliff effect" in LGD and RWA. There could be scenario where a one-notch downgrade for a sovereign asset would result in an immediate 10 times RWA increase. The ABA does not consider this an appropriate outcome for a single-A rated sovereign counterparty. Whilst the ABA understand APRA's desire for greater simplicity and transparency, we are concerned this proposal will have a material unintended consequence for banks' portfolios.

There are many countries active in international trade and finance that are presently rated in the "single A" band such as Japan and China. Australia has an important role to play in supporting investment in and the development of new regional infrastructure projects. Export Credit Agencies have a vital part to play in this regard, and Australian banks' ability to collaborate with strategic partners on a competitive basis including in relation to capital allocation for these financings, is a key ingredient to being able to deliver on this role. The ABA is concerned that this proposal may constrain the present role and future aspirations of Australian banks in global finance, particularly the Asian region, given that international banking competitors will likely be operating under a more favourable RWA regime for this important category of sovereign risk.

The ABA note that the fundamental issue is that APRA has diverted from the Basel regime by assigning the FIRB approach to sovereigns, as opposed to the AIRB approach. It is this aspect that has prompted the difficulty in designing the regulatory LGD factors.

Recommendation – the ABA recommends APRA consider a more discriminating approach to sovereign LGDs that would at least allow for some differentiation in the A rating level. The ABA recommend the inclusion of a 15 per cent LGD level for Credit Rating Grade 2[21].

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[21] APRA, Revisions to the capital framework for authorised deposit-taking institutions, Draft APS 112 Standardised Approach to Credit Risk, Attachment F, Table 21, December 2020, https://www.apra.gov.au/sites/default/files/2020-12/DRAFT%20APS%20112%20-%20clean.pdf.

Physical collateral

APRA has proposed a 30 per cent FIRB LGD supervisory estimate for "Other Physical Collateral". Under the Basel framework, however, the LGD is set at 25 per cent. It is unclear why APRA has diverged from the Basel framework and adopted a higher position for this collateral type.

The ABA notes key differences between the proposed AIRB and FIRB frameworks with respect to other collateral:

- AIRB: APS 113 Attachment B Table 4 defines both "Other Physical collateral" and "All other collateral".
- FIRB: APS 113 Attachment B Table 3 defines "Other Physical collateral".
- APS 113 Attachment E paragraph 7 defines qualitative requirements required to meet eligibility criteria associated with other "eligible" physical collateral.

To ensure physical collateral which offers genuine loss protection in the event of default is appropriately recognised, the ABA suggests amendments to the eligibility criteria outlined in draft APS 113, Attachment E, Paragraph 7. Our main concerns with the proposed eligibility criteria are:

- Its application is limited to loans and not to other forms of credit exposure (such as leases, receivables, derivatives, etc);
- The requirement for the ADI to have a perfected security interest in the collateral, whereas the same (or better) economic effect can be achieved via taking legal title to a physical asset;
- The requirement for physical inspection of inventories and equipment on at least an annual basis as part of the collateral monitoring process. This could be extremely problematic for Australian ADIs which provide asset / equipment financing, and have a significant number of such assets within their equipment finance portfolio. To inspect all items of equipment that an ADI has financed every year would require numerous dedicated inspectors. This could have several unintended consequences.
    - Many ADIs conduct facilities with large, multi-national corporates that involve the financing (and securing) of extensive technology or infrastructure equipment. An example is the financing of computer servers and other IT cloud storage related equipment, comprising thousands of items spread geographically across different countries, factories and transit locations.
    - The ABA understand the rationale for physical inspection. However:
        - If the impracticality of this means that we are no longer able to recognise the collateral benefit, this could potentially result in Australian ADIs being uncompetitive in this important internationally competitive market.
        - Australian ADIs might only participate in low volume high value asset finance business where inspection of a small number of high value assets is economical.
        - This might be problematic for SMEs, which utilise equipment finance in the high-volume lower value segment in order to finance equipment which is integral to their businesses.
- The requirement for a publicly available market price fails to recognise the nature of many physical markets where objective prices can be obtained via other means (such as reference to a publicly available benchmark price or independent valuation); and
- The criteria establishes a different standard for physical collateral assessment and valuation than is set out in the new APS 220, Attachment A (which is due to take effect no later than 1 January 2022) and could result in inconsistent application of credit policies and procedures.

Recommendation – super-equivalent variations have an impact on international comparability, and so the ABA recommends aligning the physical collateral LGD to the Basel framework. In addition, the ABA recommends that APRA amends APS 113, Attachment E, paragraph 7 in line with Appendix A – Physical Collateral of this submission which the ABA notes is in line with the eligibility criteria for other physical assets such as commercial or residential real estate, as well as the approach taken by the European Banking Authority.

Unsecured LGDs and IRB scaling factor

The ABA supports APRA's core objective to ensure adherence to the internationally agreed Basel standards while also seeking to enhance competition and improve transparency and comparability. However, the ABA notes that APRA's proposals are expected to have consequences for international comparability and competition by introducing further areas of super-equivalence including:

- Higher LGD of 50 per cent for senior unsecured exposures under FIRB: APRA is proposing a flat supervisory estimate of 50 per cent for wholesale senior unsecured exposures. This is higher than Basel's 40 per cent for corporate exposures, and could perpetuate challenges for international comparability and competition.
- Higher IRB scalar: While APRA is aligned to Basel currently (1.06x scaling factor), APRA's proposals to increase the scaling factor to 1.1x introduces a new element of super-equivalence into the capital framework given Basel's removal of the scalar.

Super-equivalence impacts the ability of Australian banks to compete internationally with global banks who are subject to regimes which are equivalent or, in some cases, sub-equivalent, to Basel. Alignment with Basel will also improve international comparability between Australian banks and international peers, increasing visibility of Australian ADIs' capital strength for overseas markets.

Recommendation – the ABA recommends that APRA aligns FIRB unsecured LGDs with Basel and removes the IRB scaling factor for wholesale exposures in line with Basel.

Trade finance LGD

The ABA notes that under the proposed framework there continues to be no "carve out" for the LGD treatment of trade finance exposures. This means that they will continue to be treated in a similar way to corporate exposures with the application of a 50 per cent LGD.

Trade finance is a transaction-based business where new documentation is required for each individual transaction, which ultimately represents a lower risk when compared with clean working capital finance. If structured correctly with inherent product controls, it is an asset class that enables banks to utilise short term liabilities more efficiently.

Applying an appropriately set LGD estimate would differentiate these products from clean working capital finance and would incentivise customers to opt for Trade products rather than other forms of clean working capital finance. This would have the effect of reducing the level of risk in the financial system as: (i) facilities are linked to verifiable underlying transactions, and (ii) the requirements for documentary evidence and visibility into underlying flows supports greater ability to fight financial crime.

Recommendation – the ABA recommends setting a specific LGD for trade finance exposures, which is lower than the senior unsecured LGD estimate. This concessional LGD should be conditionally applied on the ADI being able to demonstrate that such credit is only extended to genuine trade assets, where the ADI has the appropriate systems and monitoring to manage trade assets and that it can provide the required long term cyclical analysis to evidence the effectiveness of their controls

The PD and LGD substitution approach under FIRB

With FIRB being used for the Sovereign asset class, under Attachment B, Paragraph 44 (a) of APS 113, the ABA assumes that for ADIs this allows for the substitution of both PD and LGD based on that applicable to the guarantor or credit protection provider.

Under the “FIRB substitution” approach, an ADI must determine the risk-weight of the covered portion of the exposure by using the PD appropriate to the guarantor or credit protection provider’s borrower grade. The ADI may also replace the LGD of the underlying exposure with the LGD applicable to the guarantee or credit derivative, considering its seniority and any eligible collateral.

Recommendation - the ABA seeks clarity from APRA on how it intends for this to apply in practice for FIRB and AIRB exposures. One example is an exposure with 95 per cent coverage from Export Finance Australia (being the Export Credit Agency of Australia). Currently under the AIRB substitution method, the ADI substitutes the PD or LGD of the underlying exposure with that of the Australian Government (as calculated internally by the ADI under AIRB). Under the FIRB substitution method, the PD and LGD shall be substituted using PD & LGD pertaining to the Australian Government.

Mortgage risk-weight floor

APRA is proposing to introduce a risk-weight floor of five per cent for residential mortgage exposures under the IRB approach. The floor would be applied at the exposure level and after the relevant probability of default (**PD**), LGD and exposure at default (**EAD**) floors as well as the residential mortgage multipliers, but before the overall IRB scaling factor. APRA has noted the introduction of this floor is to act as a simple backstop in ensuring capital outcomes do not widen between IRB and standardised banks at the lower risk segment of the portfolio.

The ABA note that APRA’s proposed framework already incorporates inherent conservatism in PD, LGD floors and mortgage multipliers, and we believe additional conservatism under the proposed framework is unnecessary. In addition, while the ABA supports further alignment in capital outcomes between IRB and standardised banks, we believe a more appropriate mechanism would be for APRA to apply lower standardised risk weights for low-risk mortgages.

Recommendation - the ABA supports reducing the difference in capital outcomes between IRB and standardised banks by re-calibrating the standardised risk weights following the results of the QIS, and therefore recommends the removal of the five per cent risk-weight floor. This recalibration of risk weights should not result in higher RWs for mid-to-high LVR loans.

APS 112 Standardised Approach to Credit Risk - specific issues

Mixed collateral

APRA has proposed to exclude commercial property from the LVR calculations for residential property exposures. This approach has been proposed on the basis that it is simple, conservative, and broadly aligned with the Basel framework. The challenge with this approach is that for business lending customers with mixed collateral, it results in higher risk weights for all of their lending, higher than similarly secured commercial property, and higher than non-property secured and unsecured loans.

In some instances, the risk weight impact is so high that it may make sense from an APS 112 perspective to avoid some cross-collateralisation, which would limit the number of assets a bank has recourse to in the event of default. In other instances, high risk weights for small businesses who have various sources of security which is often cross-collateralised may result in higher capital allocation for these arrangements, impacting the cost of credit to this key section of the Australian economy. The ABA has provided examples in Appendix B – Mixed collateral of this submission to highlight these points.

The ABA would be supportive of a framework that would provide recognition of commercial property security in LVR calculation. A simple approach would be to allow the value of the non-predominant commercial property to be included in the LVR calculation. This would improve simplicity by removing the current requirement to incorporate two separate calculations into the APS 112 calculation as currently there is a calculation for predominant commercial property, and another for predominant residential property. The result of this would be that risk weights for mixed property cross-collateralised business lending customers with predominant residential property security would be [lower] than customers with commercial property security, non-property security, or no security, in line with expectations.

Such a change will support business lending customers with a non-predominant share of commercial property security to use that collateral to source funding arrangements which are capital efficient, which is permitted currently in the APS 113 approach. Large risk weight relativity differences between APS 112 and APS 113 will make structuring security arrangements more difficult, and customers will find it harder to access funding to support and grow their businesses.

Recommendation – the ABA recommends that APRA allow for the value of the non-predominant commercial property to be included in the LVR calculation.

Non-dependent residential property secured loans (business lending)

Under the proposed framework, APRA does not have a separate risk weight treatment for non-dependent residential property secured loans unlike in the Basel framework. This impacts business loans, resulting in them being treated in the same way as dependent property secured loans with risk weights closely reflecting the Basel “materially dependent” risk weights. This is in contrast to the commercial property segment, where non-dependent commercial property secured loans have lower risk weights than dependent loans. The result is that non-dependent business lending residential property security loans can end up with higher risk weights than similarly secured commercial property secured loans, non-property secured loans and unsecured loans. In many instances, this is due to the ineligibility of commercial property collateral to be used in this LVR calculation, resulting in high LVRs and therefore high-risk weights.

Recommendation - the ABA would be supportive of a framework that would provide some preferential treatment to business loans that are not-dependent on income generated from the property. One possible approach could be to treat these loans in the same category as owner-occupied principal and interest mortgages (no LMI).

Another approach could be to add a new category of “business lending – non-dependent”, with LVRs above 90 per cent instead referencing the appropriate risk weight in Attachment B of APS 112, similar to the approach used for non-dependent commercial property loans.

Removal of Trading Book Concession for Securities Financing Transactions

The ABA supports APRA's approach to expand the scope of eligible financial collateral and continue to align with Basel, by including certain securitisation exposures and certain units in unlisted trusts. However, the ABA does not support APRA's proposed removal of the concession for trading book instruments as eligible collateral for securities financing transactions (**SFTs**) as:

- SFTs over trading book eligible debt securities are pivotal in facilitating collateral and liquidity management and ADIs would be at a disadvantage to global peers due to APRA super-equivalence;
- ADI trading books are subject to appropriate governance under APS 116 as well as independent oversight by risk management;
- Global debt securities markets are deeply liquid, even at the lower end of the credit curve (e.g. average daily turnover of the US corporate bond market was US$8 billion as reported on TRACE for the period between March 2020 and February 2021[22]); and
- Historical evidence suggests that the 30 per cent haircut applicable to non-main index equities (which has been increased from 25 per cent) remains appropriate for trading book eligible debt securities, which tend to exhibit lower volatility than listed equity markets. For example, assuming an extended 20-day holding period the largest observed move in the 'Barclays US Corporate High Yield Total Return Index' since 2006 (i.e. including the Global Financial Crisis from 2008-2009), was -28 per cent.

The removal of the trading book concession for SFTs would result in financing arrangements which are legally and economically secured by collateral being treated as unsecured lending. This would impair the ability of ADIs to facilitate collateral and liquidity management and service clients.

Recommendation – the ABA recommends that APRA aligns with the Basel standard and retains the current concession for trading book instruments that would not otherwise qualify as eligible collateral to be recognised as eligible collateral for SFTs.

Credit conversion factors

APRA is proposing to retain the CCF estimates set out in the previous response to industry submissions. The ABA still considers that APRA's deviation is materially higher than the Basel standard and will impact the competitive position of Australian banks relative to international peers, both within Australia (offshore branch competitors) and in international markets.

Uncommitted Limits (Unconditionally Cancellable)

The ABA acknowledges APRA's rationale for a broadening of the "commitment" definition to include those documented as unconditionally cancellable, and we strongly support the adoption of the Basel Footnote 53 of paragraph 78 conditions to enable ongoing exclusion[23].

However, there are certain customers, markets and products where the practical implementation of Footnote 53 is difficult. For these, the 40 per cent CCF is considered overly punitive when considering the actual experience and observed CCF of banks operating in this segment.

ADIs may legally reduce or cancel these facilities at any time and tools and processes are in place to enable ongoing monitoring of the borrower's creditworthiness. Empirical studies on defaulted borrowers conducted by some member banks indicate that CCFs for facilities with a cancellable limit component are at most negligible (and often negative). This reflects the refined, well established high risk customer management procedures undertaken by banks' specialist teams.

[22] TRACE is the Trade Reporting and Compliance Engine operated by FINRA and used by market participants to report OTC transactions relating to fixed income securities. See Bloomberg, TRACE <GO>, TFLO Corporate Bond volume 9.
[23] Basel III: Finalising post-crisis reforms, (December 2017), Standardised approach, paragraph 78, footnote 53, page 25 https://www.bis.org/bcbs/publ/d424.pdf.

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Many of these arrangements involve material transaction-based limits for large and multi-national corporations, where Australian banks are directly competing with large offshore financiers. Such limit arrangements are a central pillar of these banking relationships, within a very competitive (price-sensitive) market.

The ABA considers that this material divergence in treatment could significantly compromise the international competitiveness and viability of Australian banks in the global institutional market. Australian banks will be at a distinct competitive disadvantage to those banks regulated by jurisdictions that have adopted the lower Basel requirements. This will effectively create a regulatory barrier to entry and expansion for domestic banks to compete in international financial markets such as institutional banking receivables finance.

APRA's stated rationale for disbanding the unconditionally cancellable category are: (i) a CCF of 10 to 20 per cent for the types of products that are likely to remain in this category (e.g. overdrafts), is not supported by empirical evidence; and (ii) it has been applied inconsistently across the industry and inappropriately applied to facilities that are not unconditionally cancellable in practice.

Recommendation - the ABA considers it would be appropriate for APRA to consider the re-inclusion of a dedicated Unconditionally Cancellable CCF of 10 to 20 per cent where Footnote 53 conditions are not practicable, which would more closely align to the Basel framework (10 per cent). This should be conditioned around certain rules to ensure consistency in application. Examples where the ABA believes this suggested CCF would not be appropriate where:

- The facility is not cancellable at the ADI's discretion (allowing for a legally appropriate notice period) and the ADI does not have the right at any time to decline or suspend an application to draw under the facility.
- Some form of facility fee is levied.

Project finance

In the interest of simplicity, APRA is proposing to remove the different categories of project finance exposures and replace these with a single category risk-weighted at 110 per cent. APRA considers this risk weight to be appropriate and in line with the Basel framework for the project finance portfolio.

The application of a single risk-weight will introduce distortions into the market. Most international banks that participate in project financing are subject to the Basel standard and the ABA has concerns that requiring Australian banks to apply one risk-weight could impact their ability to compete with these international banks, putting them at a distinct disadvantage.

Australian banks that participate in this market have the capability to readily distinguish between the different phases / characteristics of their project finance exposures, and they should be given the ability to apply different risk weights accordingly in line with the Basel framework.

Recommendation – APRA should consider allowing ADIs the ability to apply different risk weights to project finance exposures. The ABA supports an approach that would provide ADIs with flexibility to either elect the simplified approach of 110 per cent risk weight or undertake the necessary assessment to classify project finance exposures as per the Basel framework.

Material positive correlation

The ABA notes APRA is proposing an update to the definition of "material positive correlation" which is used to assess the eligibility of credit risk mitigation (**CRM**) techniques, including collateral. The proposed definition in draft APS 112, Paragraph 24, requires an assessment of the correlation between the credit quality of the counterparty with the CRM technique used. Compared to the current standards (APS 112, Attachment G, Paragraph 12), APRA's proposed definition broadens the scope of the correlation assessment from being solely concerned with the relationship between the counterparty and collateral to include other cases of correlation (even in the absence of a relationship).

While the ABA supports the overall direction of the change, the ABA recommends that APRA provide further clarification on the considerations for material positive correlation to enhance the risk-sensitivity of the definition and enable CRM to be used where the nature of the transaction ensures that the collateral is likely to mitigate or prevent loss at the point of default.

Recommendation – the ABA recommends that APRA amends its proposed definition set out in draft APS 112, Paragraph 24 to include the additional paragraph provided in Appendix C – Material positive correlation of this submission.

Definition of a small ADI

The ABA supports APRA's proposal to include a simplified reporting and compliance framework for smaller, less complex ADIs however is concerned that the qualifying criteria as currently drafted may create unintended consequences for small ADIs around the management of interest rate risk and funding. Rather than qualify non-centrally cleared derivative exposures to be immaterial, the ABA is of the view that the purpose for which any non-centrally cleared derivative exposures are entered into should be considered instead. For example, derivatives that are entered into for hedging purposes in accordance with a Board approved hedging policy and that are reported to APRA under the proposed APS 117 IRRBB should be excluded from the test in the Small ADI definition.

In addition, the definition of funding offshore should also be clarified so as to exclude any AUD denominated funding that is issued to an offshore investor where the currency risk of such funding resides with the underlying investor. The ABA would also be supportive of APRA providing these clarifications to the definition of a Small ADI in an accompanying practice guide.

Recommendation – the ABA recommends APRA makes amendments to its qualifying criteria for a small ADI to include the purpose for which any non-centrally cleared derivative exposures are entered into. APRA should also clarify the definition of funding offshore to exclude AUD denominated funding that is issued to an offshore investor.

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Issues relevant to both APS 112 and 113

External ratings

APRA has amended APS 112 to be more consistent with the Basel framework by introducing the requirement for ADIs not to use external ratings for bank counterparties that include uplifts for implicit government support. The risk weight for these exposures would be assigned based on the stand-alone credit rating of the ADI.

The current external ratings requirements under APS 112 are already operationally complex and detailed before the introduction of this additional criteria. This requirement would require ADIs to obtain the rating agency reports from Standard & Poor's **(S&P**), Moody and Fitch for the available ratings and strip out the "implicit government support" from the rating 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 or explicit which is not always clearly defined in the report. The rating methodologies are also different across three rating agencies which complicates the process further.

Imposing this requirement will result in additional data fields being introduced for each credit rating agency as ADIs will be required to store both the issuer credit rating including government support as well as the rating excluding government support. The alternative would require the ADI itself to judgementally adjust the rating to exclude the government support element, which would be particularly difficult for counterparties such as banks, where the implied support of the local sovereign is often intrinsically bound with the bank's credit profile.

The matter is further complicated for multi-national corporations (particularly in Europe) where the counterparty has legal and operational representation across multiple jurisdictions.

Finally, ABA member banks would need to seek further guidance from APRA on what it considers would constitute implicit government support, and what would need to be removed from the published external credit rating for the ADI to meet this proposed requirement.

Recommendation – 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 "stand-alone" credit rating would be overly punitive.

If APRA intends to not permit the use of these ratings, then 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. This proposal will result in significant operational difficulties in capturing the data from a large number of customers in the SME segment and may raise a need to check this on a more frequent basis in the event that unrated customers obtain a rating. 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.

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.

Lender's mortgage insurance (LMI)

Capital reductions for LMI

The ABA recognises APRA's consideration of the value of LMI in terms of risk weights. APRA considers that LMI is not a direct substitute for capital held by an ADI and maintains its 20 per cent discount for residential mortgage with LMI cover. It considers the key differences affecting its decision to reduce the LMI discount is the potential for non-payment, reduced fungibility, reduced capital strength of LMI providers compared to banks, and potential concentration risk among LMI providers.

The ABA note that these features of the LMI product are not new and are currently present in the current capital framework. It is unclear to the ABA what additional risk these features pose under the Basel III framework compared to the current framework to warrant such a significant policy change.

We are concerned by APRA's proposed credit risk weighting for residential mortgages with LMI. The ABA still considers a reduction of between 30-50 per cent for mortgage risk-weights would be an appropriate mechanism to recognise the benefits of LMI, such as:

- A meaningful reduction in LGDs for loans which meet the minimum of 40 per cent LMI coverage;
- LMI coverage is less prone to procyclicality; and
- It enables greater competition from standardised banks for high LVR loans.

The reduced benefits for holding LMI seem to be a distinct change in prudential policy and likely to have significant impacts on the amount of credit available to first home buyers.

Recommendation - the ABA recommends APRA consider increasing the discount for LMI backed mortgage risk weights for both IRB and standardised banks.

Scope of insurance products

The ABA believes that this proposed revision to the capital framework is an opportunity for APRA to expand the scope of insurance product recognition beyond LMI.

The ABA notes that LMI is primarily conducted with two domestic financial institutions in Genworth and QBE. While LMI reduces mortgage risk, it may increase mortgage insurance concentration risk and decrease financial system stability. Additionally, it can reduce the incentive for ADIs to pursue well-diversified, multi-lined reinsurance options to decrease their mortgage risk.

Widening the scope of insurance options, through using well-rated risk protection programs, can provide diversification benefit to lenders mortgage insurance concentration risk.

Recommendation - the ABA recommends APRA broadens the scope of insurance recognition to include risk protection programs.

Revaluation of security

As raised in our June 2019 submission, the ABA has concerns around the narrow opportunities available to borrowers to revalue their security for both residential and commercial borrowings. We consider the highly prescriptive nature of the circumstances when a borrower can revalue security is likely to lead to unforeseen and unwanted outcomes. This includes higher churn of mortgage products and drastic changes to commercial lending.

Residential borrowings

The ABA considers that the situations proposed by APRA in which a revaluation can be undertaken to increase the value of a property for risk weighting are too narrow. A customer may seek a revaluation in order to obtain a lower mortgage interest rate. If the only option is a new mortgage to access a revaluation, this will in turn lead to an increase in the number of new mortgages taken out which will incur additional expenses for ADI's, which will be passed on to borrowers. This higher cost is not in the interests of the consumer and it is questionable how this will reduce risk in comparison to current practice.

Commercial borrowings

For commercial properties, modifications may be made to the contractual arrangements (rather than the property itself), such as adjustments to the lease or quality of the tenant which can increase the value of the property. A borrower may wish to revalue the security in these cases to access a lower interest rate and/or alleviate restrictions on their loan. However, the draft standards apply a narrow application of when revaluations are permitted and could lead to market churn and an increase in short term funding. It also does not appropriately reflect the risk of the exposure.

In addition, the ABA notes there exist inconsistencies between APS 112 and APS 113 as it relates to commercial property revaluations. Under the current proposal, it appears that ADIs will be required to capture two different values for all Basel Wholesale exposures that are secured by property. This would include:

- The APS 112 value – the collateral value at origination, or the eligible updated valuations where there is a new loan application or there are modifications.
- The APS 113 value – the collateral value at no more than the current fair value under which it could be sold under contract between a willing seller and an independent buyer on the date of valuation.

In most cases, the ABA expects that these valuations will be the same, however, scheduled revaluations will result in the APS 113 value widening over time from the APS 112 value, particularly, for Corporate exposures. The ABA queries whether this potential divergence is intended by APRA.

Recommendation – APRA should expand the circumstances for both residential and commercial property in which a property revaluation is permitted for LVR calculations.

The ABA also supports the consistent application of the two standards to property valuations. This could be achieved by APRA revisiting the frequency of property revaluations for commercial property required under APS 113 and this then be extended to APS 112.

Consistency between standards

Asset class definitions

The ABA notes that there are several instances of differences in the definition of asset classes across APRA's proposed draft APS 112 and APS 113. Having differences in asset class definitions across APS 112 and APS 113 creates complexity for operational implementation and also for investors, given the new disclosure requirements to report under both standardised and IRB approaches going forward. Acknowledging that the two standards are not intended to align on asset class definitions, the ABA would like to highlight to APRA some asset classes which may appear to be similar to external parties under APS112 and APS113 but are different.

For example:

- The definitions of income-producing real estate in APS 113 and commercial property in APS 112 are not completely aligned. The definition in APS 112 refers to being secured by immovable real property while the APS 113 definition only refers to the repayment being primarily dependent on the cash flow generated by the asset.
- Non-Bank financial institutions (e.g. Insurance companies) are included as a corporate exposure in APS 112, but under APS 113 they form part of the Financial Institution which includes Banks as well.
- Firm-size adjustment definitional differences may result in differences in measurement between STD and IRB ADIs. APS 112 proposes use of the latest financial year financial statements whereas APS 113 references a three year average.

Recommendation - to aid in the operational implementation of the standards by Australian banks and for consistency of reporting, the ABA recommends the alignment of definitions across the standards, where possible. Consistency will also benefit IRB banks who will be required to implement the standardised approach in full, in addition to the existing IRB approaches. Having definitions that are inconsistent makes the framework more complex for investors to understand given disclosure requirements.

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Related prudential standards

Net Stable Funding Ratio (APS 210)

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. 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 weight 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 - APRA should consider the impacts of its changes to APS 112 on the NSFR calculations when it undertakes a revision and recalibration of APS 210. The ABA does not believe that liquidity risk has changed from the introduction of the new standardised credit risk approach. The ABA would like APRA to recalibrate the NSFR calculations when it undertakes a revision of APS 210 to ensure that the NSFR remains the same as today.

Aggregation of counterparties (APS 221)

For purpose of defining "business-related exposure", APRA proposes to adopt in full the Prudential Standard APS 221 Large exposures (**APS 221**) criteria. The ABA notes that APS 221 requires an ADI to treat a group of connected counterparties as a single counterparty. The standard goes on to outline the criteria of when two or more counterparties are linked, and this linkage would constitute the existence of a group of connected counterparties.

The application of the criteria to reflect an "economic interdependence" relationship could cause some unintuitive asset class classifications under the proposed framework. For example, a small transport company that has a long-term contract with a multi-national corporation which compromises more than 50 per cent of the company's income, would under APS 221 be aggregated with the multi-national corporation and classified as a Large-sized corporate under the proposed framework, even though there is no common ownership, management or control. This will result in a perverse outcome as:

- The small transport company clearly does not have the same risk characteristics as a Large-sized corporate. The application of the minimum requirements of assessment and rating process to this entity class would not be appropriate for the small transport company.
- Operationally, internally the small transport company would need to be "grouped" with the multi-national, with the associated management and logistical problems that would arise. The re-segmentation exercise is already a complex one for banks, and our concern is that introduction of the full APS 221 concepts will be extremely difficult to implement in practice.

In addition, it is not common practice for a SME Corporate and SME Retail customer to provide "consolidated financials" that are aligned to the APS 221 definition of aggregation. SME customers will generally provide their bank with financial statements, but these will not be consolidated and will be limited to the part of their group that the ADI will have recourse too. It will be these financial statements that are used to determine the customer's probability of default and repayment capacity.

Recommendation – the ABA recommend APRA remove the requirement to group connected borrowers based on economic interdependence as per the APS 221 provisions. Grouping would be based primarily on material control / influence and / or majority ownership, i.e. as applies today in this segment.

In addition, the ABA recommends APRA remove paragraph 42 (b) in draft APS 113 and adjust the definition of "consolidated annual review" to reflect market practice and the existing information available from these customers by removing the requirement for the accounts to be audited and consolidated, thereby permitting ADI's to utilise the annual revenue used to determine the customer's probability of default.

Consistency in servicing standards

The ABA notes that servicing criteria are outlined in APS 112 in the definition of non-standard, in APRA's Residential Mortgage Lending guidance (**APG 223**), and APS 220. It is unclear, for example, if "consecutively performing" (APS 112, Attachment A, paragraph 21) and "performing consecutively" (APS 112, Attachment A, paragraph 22) relate to the APS 220 definition (i.e. are not 90 days past due).

Recommendation - the ABA would encourage APRA to consider the consistent application of servicing standards across these standards and guidance, using APS 112 as the base framework.

Other issues

The ABA would like APRA to take this opportunity to revisit other capital framework issues not considered in this consultation, ahead of the finalisation of the capital framework standards.

Securitisation

The ABA notes that APRA continues to not recognise “synthetic” or “funding only” securitisations for capital relief in the same way as other forms of securitisation products. This is at odds with the general Basel framework, and it is unclear to the ABA why such a divergent treatment is being applied by APRA.

Recommendation - the ABA would be supportive of undertaking further engagement with APRA to develop a criterion that would enable these types of securitisation products to have a similar treatment to other forms of securitisation.

Facility Tenor and Contractual Provisions

The ABA refers to the facility maturity provisions contained in APS 113, which provides for a maximum of five years in the absence of a defined maturity date. In certain circumstances, facilities might be documented without a defined expiry date, or with an overall maturity date exceeding five years. However, they might also contain certain tenor and contractual protections that afford comfort to a lender.

An example of these is what are sometimes termed “Pay and Walk” clauses for Performance Bonds (with such clauses also used in other products like bank guarantees). These allow the ADI to, at its sole discretion, crystallise the performance bond, make physical payment to the beneficiary for the bond face value on behalf of the customer/ applicant, and in turn seek the equivalent compensatory payment from the customer/ applicant (or alternatively establish a funded facility for all or part of that amount under newly agreed terms and conditions).

Recommendation - the ABA recommends that these commonly practiced arrangements be provided for in maturity calculations along the following lines:

- Where contractual documentation, covering an individual instrument and the indemnity or facility that instrument is issued under, stipulate that all cash flows can become unconditionally payable upon immediate demand or notice period of 30-90 days, “M” = the date at which repayment would occur, subject to the one-year floor.
- Where contractual documentation does not allow for immediate demand or notice period, and instrument maturity date is greater than committed facility maturity date, “M” = the committed facility maturity date on basis that the ADI may elect to not renew the commitment and call for return of instrument, again subject to the one-year floor.

Capital Adequacy: Interest Rate Risk in the Banking Book (APS 117)

The ABA notes that APRA is extending the application of risk management requirements within APS 117 to all ADIs, so that each ADI must have a framework for managing Interest Rate Risk in the banking Book (**IRRBB**) (including spread risk). While APRA notes that it expects these frameworks to be commensurate with the level and complexity of each ADI’s IRRBB exposures, we remain concerned that for many ADIs, particularly foreign bank branches and smaller less complex ADIs, the proposal is not a proportionate response.

The distinction between larger institutions and smaller ADIs and foreign branches is something which APRA has recognised previously in its liquidity framework setting and a similarly nuanced approach for APS 117 would be welcomed by the industry. Non-material levels of interest rate risk for an ADI with lower total exposures, or exposures that are insignificant in their global firm context, simply do not require the burdensome structures proposed by the revised draft of APS 117.

While APRA might suggest “commensurate” application will deliver proportional outcomes, in practice using a framework currently reserved for ADIs with over $100 billion in exposures for all prudentially regulated ADIs will result in a significant and unnecessary increase in cost and complexity as firms will be reluctant to risk scaling back the requirements significantly given the prudential nature of the related supervision.

Further, allowing foreign bank branches to manage risks from head office will ensure APS 117 reflects the structures that have been established and supported internationally by the Financial Stability Board and promoted by IOSCO.

Recommendation - the ABA supports APRA applying the existing CPS 220 framework that allows non-IRB ADIs to manage their risk in a proportionate way and will require active thought from management and the board of each institution as to what the ‘right-sized’ response is for their organisation. It also allows scope for each institution to manage their risk in the way that best mitigates the challenges posed by their own business model and funding structure and should generate a better prudential outcome.

Appendix A – Physical collateral

APS 113, Attachment E, paragraph 7:

An ADI may recognise other physical collateral where the following conditions are met:

~~(a) the ADI is able to demonstrate the existence of liquid markets for the disposal of collateral in an expeditious and economically efficient manner.~~

(b) ~~the ADI is able to demonstrate that there are well established, publicly available market prices for the collateral. The ADI must also be able to demonstrate that the amount it will receive when collateral is realised does not deviate significantly from these market prices.~~ **The ADI is able to establish an objective price or market value which represents the estimated amount for which the asset would exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction**;

(c) The ADI must have a ~~perfected~~ first priority security interest **or legal title** to the collateral, such that it has priority over all other claims to the realised proceeds of the collateral. The security interest must be legally enforceable in all relevant jurisdictions, and the ADI must be able to realise the value of the collateral within a reasonable timeframe, **given the nature of the collateral**;

(d) The ~~loan~~ **relevant** agreement must include detailed descriptions of the collateral and the right to examine and revalue the collateral at the sole discretion of the ADI. **The ADI must have policies and procedures in place addressing their exercise of the right to examine the collateral**;

(e) The collateral is valued at no more than the current fair value under which it could be sold under contract between a willing seller and an independent buyer on the date of valuation;

(f) The ADI monitors the value of the collateral on at least an annual basis. More frequent monitoring is required where the market is subject to significant changes in value. For inventories and equipment, the ADI is to undertake physical inspection / review as considered appropriate and practicable for each lending and collateral scenario ~~for inventories and equipment, the periodic revaluation process must include physical inspection of the collateral~~;

~~(g)~~ The ADI must have clearly documented credit policies and procedures that **are consistent with the requirements in APS 220, Attachment A – Collateral Valuation**; ~~detail the:~~

~~(i) Types of collateral accepted by the ADI, and policies and practices in respect of the appropriate amount of each type of collateral relative to the exposure amount;~~

~~(ii) ADI's ability to liquidate the collateral readily; and~~

~~(iii) ADI's ability to objectively establish a price or market value of the collateral, frequency with which the value can be readily obtained, and the volatility of the value of the collateral. The periodic revaluation process must pay particular attention to 'fashion sensitive' collateral to ensure that valuations are appropriately adjusted downward of fashion, or model-year, obsolescence as well as physical obsolescence or deterioration;~~

(h) The ADI ensures that the collateral is adequately insured; and

(i) The ADI monitors the risk of environmental liability arising in respect of the collateral.

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Appendix B – Mixed collateral

Example 1 - a business lending customer example with a cross-collateralised loan - the value of mortgage is used to support both loans and the value of Commercial property is dropped from the LVR

Loan Type	Cross-collateralised	Outstanding + Committed Undrawn + Accrued Interest + Defaulted Provisions	RP Security Amount	CP Security Asset	CP Security Amount	Predominance	LVR	RW Category	RW	RWA $
OO P&I No LMI Mortgage	Y	$500,000	$700,000		$0	RP	104%	RP OO P&I No LMI: LVR > 100%	85%	$425,000
Business Loan SME Retail	Y	$800,000	$550,000	CP Asset 1	$500,000	RP	104%	RP - No LMI: LVR > 100%	105%	$840,000
Total		**$1,300,000**	**$1,250,000**		**$500,000**				**97%**	**$1,265,000**

Example 2 - as outlined below, for mixed collateral loans where the value of Commercial property is higher than Residential Property (a small increase of $50k on Example 1 above) it becomes the predominant security, and this results in mixed collateral loans with higher commercial property receiving lower risk weights than loans with more residential property

Loan Type	Cross-collateralised	Outstanding + Committed Undrawn + Accrued Interest + Defaulted Provisions	RP Security Amount	CP Security Asset	CP Security Amount	Predominance	LVR	RW Category	RW	RWA $
OO P&I No LMI Mortgage	Y	$500,000	$700,000		$0	RP	108%	RP OO P&I No LMI: LVR > 100%	85%	$425,000
Business Loan SME Retail	Y	$800,000	$500,000	CP Asset 1	**$550,000**	CP	74%	CP - No MD: > 60% LVR	75%	$600,000
Total		**$1,300,000**	**$1,200,000**		**$550,000**				**79%**	**$1,025,000**

Example 3 - because of the exclusion of mixed collateral, a decision to exclude the residential property as security for the business loan (assuming no other internal credit requirements) would result in a lower RWA even though it means the bank has less recourse in the case of default

Loan Type	Cross-collateralised	Outstanding + Committed Undrawn + Accrued Interest + Defaulted Provisions	RP Security Amount	CP Security Asset	CP Security Amount	Predominance	LVR	RW Category	RW	RWA $
OO P&I No LMI Mortgage	N	$500,000	$1,250,000		$0	RP	40%	RP OO P&I No LMI: LVR < 50%	20%	$100,000
Business Loan SME Retail	N	$800,000		CP Asset 1	$500,000	CP	160%	CP - No MD: > 80% LVR	75%	$600,000
Total		**$1,300,000**	**$1,250,000**		**$500,000**				**54%**	**$700,000**

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Appendix C – Material positive correlation

<u>APRA's proposed APS 112, Paragraph 24:</u>

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

<u>ABA's proposed addition to APS 112, Paragraph 24:</u>

In determining whether a CRM technique has a material positive correlation in accordance with paragraph 24, APRA expects ADIs to consider the characteristics of the obligor, the transaction, and the collateral. In each case the ADI should consider whether the relevant characteristics might, either on their own or in combination with other relevant characteristics, give rise to a material positive correlation between obligor creditworthiness and collateral value such that the collateral might not provide effective mitigation at the point of obligor default. Conversely, where collateral is expected to be effective at mitigating credit loss at the point of default, it is not considered to have a material positive correlation.