Australian Banking Association

02 February 2021

Mr Gideon Holland
General Manager, Policy Development
Policy and Advice Division
APRA
By email: ADIpolicy@apra.gov.au

Dear Mr Holland

Revisions to APS 220 Credit Risk Management

Thank you for the opportunity to provide feedback to APRA on its proposed revisions to Prudential Standard APS 220 Credit Risk Management (**APS 220**) in response to the Government's proposed reforms to consumer credit laws. The Australian Banking Association (**ABA**) welcomes the intent of alignment between APS 220 and the Government's proposed National Consumer Credit Protection Amendment (Supporting Economic Recovery) Bill 2020 [Provisions] Credit Reform Bill (**the Bill**).

With the active participation of 24 member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy, and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA supports the Government's reforms to the National Consumer Credit Protection Act. ADIs expect the reforms to result in clear benefits for customers, by simplifying credit laws and boosting borrower confidence, while maintaining strong customer protections.

The ABA understands that APRA is proposing:

- to align the implementation date of the new APS 220 more closely with the Government's proposed consumer credit reforms if this is earlier than 1 January 2022. APRA will not implement the new APS 220 any earlier than 1 April 2021; and
- an amendment to the new APS 220 that would require ADIs to assess an individual borrower's repayment capacity without substantial hardship.

The ABA's feedback on these proposals is detailed below.

Implementation date: Phased implementation needed

The ABA's key concern is that the proposed shortened implementation timeframe is not achievable. ADI's are not able to implement a compliant APS 220 framework before 1 January 2022.

The ABA considers that at a high level, ADI's credit risk practices are likely to comply with the intent of APS 220; however, there are a range of areas where the standard goes beyond the existing standard which will require, among other things:

- review of existing system capabilities and potential remediation and testing
- enhancement to internal policies and other documentation (e.g. stress testing documentation)
- independent validation of any changes to models

- Ensure system capabilities and data capture meet new Reporting Standard ARS 220 Credit Risk Management, and
- assurance of above (and other new requirements).

In contrast to APRA's view, an earlier implementation date is likely to create material additional regulatory burden and is subject to significant internal resource constraints. This is because of:

1) COVID-19
2) Delayed finalisation of APG 220; and
3) Related prudential requirements not yet finalised or underway.

1. Focus on customers due to COVID-19

While the final APS 220 standard was published on 12 December 2019, with a 1 January 2021 implementation date, ADIs deprioritised APS 220 implementation projects following APRA's March 2020 announcement that APRA had suspended the majority of its planned policy and supervision initiatives in response to the impact of COVID-19.

APRA's decision was intended to allow APRA-regulated entities to dedicate time and resources to maintaining their operations and supporting customers.[1]

APRA also reconsidered the implementation dates and transition timeframe for prudential and reporting standards that had been recently finalised but not yet implemented, such as APS 220, to allow ADIs to give their fullest attention to the impact of COVID-19.

On 16 April 2020, APRA announced the deferral of the APS 220 implementation date to 1 January 2022. Accordingly, ADIs followed this advice, re-allocated resources from regulatory implementation, and focused support on customers affected by COVID-19. This support is widely acknowledged to have been a key contributor to a better-than-expected economic outcome.

2. Prudential Practice Guide APG 220 Credit Risk Management essential

As a result of APRA's 2020 suspension of policy activities, APRA have not yet released the final Prudential Practice Guide APG 220 Credit Risk Management (APG 220) which provides essential guidance on APRA's view of sound practice in particular areas such as new requirements. To implement the new APS 220, it is imperative that APG 220 is available well in advance. The finalised APG220 will also provide additional clarity when considering those areas where the standard required goes beyond the existing standard, referred to above.

APS 220 proposed new requirements in the following areas:

- credit risk management, including credit standards and the ongoing monitoring and management of an ADIs credit portfolios over the full credit life-cycle
- asset classification and provisioning, taking into account updated Basel Committee on Banking Supervision (Basel Committee) guidance on credit-related matters and recent changes in accounting standards, and
- valuation of collateral in response to the recommendations of Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry recommendation.

As noted in the ABA 19 March 2020 APG 220 submission, further clarity and consistency is needed in the final APG 220 to allow compliant APS 220 implementation[2]. These include:

- The Role of the Board and senior management

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[1] Australian Prudential Regulation Authority (APRA), 23 March 2020, Media Release, retrieved Feb 2021 https://www.apra.gov.au/news-and-publications/apra-adapts-2020-agenda-to-prioritise-covid-19-response
[2] Australian Banking Association (ABA), 19 March 2020, APG 220 Credit Risk Management Consultation: Submission, retrieved February 2021, https://www.ausbanking.org.au/wp-content/uploads/2020/04/20200312-APG-220-Credit-Risk-Management-Submission.pdf

Australian Banking Association

- Credit origination and assessment and approval; and
- Non-performing exposures.

The ABA have since identified more sections of APS 220 that need clarification as implementation of APS 220 has progressed (see Attachment A). Given this, APS 220 implementation ahead of 1 January 2022 is not feasible given APG 220 is not yet available.

3. Implementation requires finalisation of other prudential requirements

There are a number of related prudential standards that need to be finalised to allow the early implementation of APS 220. These regulatory projects while held in tandem also take away internal resources from APS 220 early implementation. Project examples include the finalisation and implementation of the Reporting Standard ARS 220 Credit Risk Management and the implementation of the new Capital Framework (Basel III).

Alternative implementation approach

For the above reasons, the ABA suggests a staged implementation of APS 220 to deliver a more proportional response. The ABA understands the need to bring forward the implementation of APS 220 to align with the implementation of the Bill and appreciates APRA's commitment to not implement before 1 April 2021. At this stage, the implementation date is of the Bill is unclear. The Bill is currently subject to a Senate Inquiry with a final report to Parliament due 12 March 2021. Given this, it is highly unlikely that the Bill will be passed by 1 April 2021 given Parliamentary timings.

Further, the Government indicated in the release of the Bill that it will "rely on the sound credit assessment and approval process" to ensure "strong protections for vulnerable customers". As a result, the ABA considers that APS 220 processes associated with credit assessment and approval which provide the consumer protections are critical for alignment with the Bill, whereas the remaining APS 220 sections can be implemented at a later date (see APRA's Figure 1 below).

The following Figure 1 describes the main components of the final standard:

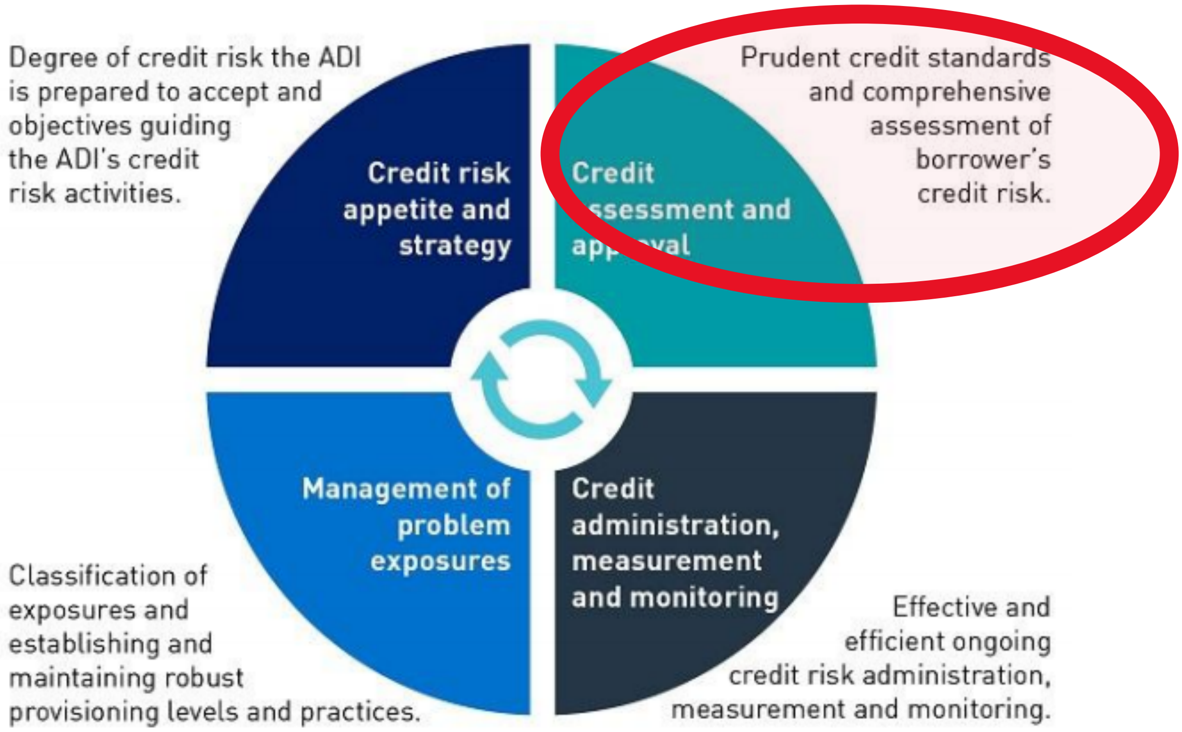

Figure 1. Main components of APS 220

As a result, the ABA suggests that:

- the early implementation of APS 220 paragraph 41 and 44 is more explicitly linked to the date Royal Assent is received on the Bill. This is consistent with APRA's commitment to make any changes to APS 220 contingent on the Government's reforms passing as legislation, and
- the remaining APS 220 requirements implemented by 1 January 2022.

Regulatory administration

It is envisaged that phased implementation could be achieved administratively in either of the following ways:

1) Letter to ADI's effectively "switching on" the new APS 220 paragraph 41 and 44 for non-business loans upon Royal Assent with the remaining requirements implemented from 1 January 2022; or
2) Similar to APRA's approach to COVID-19 deferrals, a new attachment to current APS 220 could be created that requires the new APS 220 paragraph 41 and 44 for non-business loans to be implemented upon Royal Assent with the remaining requirements would apply from 1 January 2022.

During any transition period, it is assumed that ADI's will continue to comply with the provisions of the existing APS 220.

Consideration of other implementation options

The ABA also considered whether APS 220 could be implemented in full, with a 'pragmatic' enforcement and supervisory approach by APRA. This would mean that APRA would supervise based on "the thrust of APS 220" being met and the remaining aspects of APS 220 compliance would be subject to regulatory leniency until 1 January 2022.

The ABA sees several problems with a 'pragmatic' approach to early implementation and would not support this approach. This is because:

- Further clarity is required on a 'pragmatic' approach as this is open to interpretation and may lead to inconsistency and confusion between the regulators, industry and the community.
- Lack of certainty around compliance expectations and dates creates challenges in attracting and retaining skilled internal resources. These resources are subject to competition from other regulatory projects (such as Capital Framework implementation) with due dates being a key factor in prioritisation decisions.
- BEAR accountability. Nominated accountable officers under BEAR assume significant personal and professional risk if compliance cannot be assured. A 'pragmatic' approach may expose a BEAR accountable person to unnecessary and avoidable risk.
- Compliance teams, internal and external audit will be adversely impacted, with a 'pragmatic' approach causing issues with compliance testing of internal controls, processes, policies and procedures. A pragmatic approach may raise concerns for an Auditor undertaking the functions outlined in Prudential Standard, APS 310 Audit and Related Matters
- Non-compliance with APS 220 raises significant reputational and political risk. Consumers and commentators will be expecting full compliance by ADIs from the implementation date. APS 220 implements Banking Royal Commission outcomes identified as important to the fair treatment of customers. Any non-compliance is unlikely to meet community expectations.
- The Australian Financial Complaints Authority (AFCA) will be relying on APS 220 from the implementation date to assess consumer complaints. Uncertainty regarding what aspects

of APS 220 are implemented is unlikely to be taken into consideration in AFCA's decision making. In effect, requiring ADIs to be fully compliant from an early implementation date.

For these reasons above the ABA does not support a pragmatic' approach to supervision and enforcement to APS 220 in the event that early APS 220 implementation is required.

Substantial hardship

The ABA supports the modification to paragraph 41, being the inclusion of the 'substantial hardship' requirement for exposures to individuals subject to:

- APRA including a minor amendment clarifying that 'substantial hardship' is only applicable to loans for personal, domestic or household purposes or for residential investment property purposes (but not where the credit is for other personal investment purposes.)
  - The ABA understands the purpose of the proposed modification to APS 220 is to achieve consistency in obligations between ADI and non-ADI lenders following proposed reforms to the consumer credit laws. We understand that the obligation in non-ADI standards is to assess an individual borrower's capacity to repay credit without substantial hardship does not apply to lending with a small business purpose (whether alone or with other purposes), or to any other credit not regulated by the Credit Act.
  - The proposed Bill and Treasurer's associated media release notes that the Bill will 'remove the ambiguity regarding the application of consumer lending laws to small business lending'.[3]
  - Without this clarification, the inclusion of substantial hardship could mean that the Bill "falls short" of its intended purpose to ensure consistent obligations between ADI and non-ADI lenders and to reduce barriers to business lending.
- APRA clarifying the focus of APS 220 is on the ADI's credit approval and assessment process.
  - The focus of APS 220 is on the ADI's credit approval and assessment process rather than on obligations that apply to each credit contract. We note that the proposed sentence that would be inserted into APS 220 would require an ADI to assess *an individual's* capacity to repay credit without substantial hardship. We understand that this is a requirement for an ADI to have *systems and processes* in place to ensure that the lender assesses whether an individual borrower can repay the loan without substantial hardship rather than a contract-specific requirement. This could be made explicit in the proposed amendment.
  - The proposed amendment is to ensure consistent obligations between ADI and non-ADI lenders following proposed reforms to the consumer credit laws. The following minor amendments could clarify these points.

  For exposures to individuals, an ADI's credit assessment and approval process must assess the individual's capacity to repay credit without substantial hardship where that credit is provided wholly for personal, domestic or household purposes or for residential investment property purposes (but not where the credit is for other personal investment purposes).

Further alignment with Credit Reform Bill needed

The ABA notes that the Government intends to introduce a 'borrower responsibility' principle into the consumer credit framework to improve efficiency in the credit assessment process. The ABA supports introducing this principle. However, the ABA notes this principle will only be reflected in legislation for non-ADIs and there will not be a mirroring principle included in the regulatory framework for ADIs. Given this, the ABA is seeking further clarification from APRA on how it will achieve the Government's

[3]The Hon Michael Sukkar MP, Minister for Housing and Assistant Treasurer, and The Hon Josh Frydenburg, Media Release, retrieved 1 February 2021, https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/simplifying-access-credit-consumers-and-small

intent under the prudential regulatory framework. It is important that this principle be applied to ADIs to ensure that there is a ‘level playing field’ for both ADIs and non-ADIs.

As noted earlier, the ABA supports the passage of the Bill and we believe that the alternative implementation proposal and drafting amendment supports its implementation. I look forward to discussing these proposals further at your convenience.

Yours sincerely

Karen O’Brien
Policy Director
Phone: 0450615148
Email: karen.obrien@ausbanking.org.au

Australian Banking Association

Attachment A - APS 220 Implementation Issues for Prudential Practice Guide (APG 220)

Item	APS 220 Reference	Issue	Questions	Proposal
	Independent Valuations			
1	Paragraph 47	In APS 220, paragraph 47, APRA has proposed that all valuations must be appraised independently from the credit origination, assessment and approval process. As per the Discussion Paper, this proposal is "in line with the recommendations of the Royal Commission" which related specifically to land and agricultural land. Banks take security over a wide range of collateral and while it is industry practice to obtain independent valuations for real estate and land, it is not practical or industry practice to obtain independent valuation for certain other forms of secured collateral such as those that support wholesale lending.	Could APRA clarify the intention and scope of paragraph 47, specifically the extent to which an independent 2nd line sign-off of certain valuations to support wholesale lending fulfils APRAs intentions and expectations for this section of the standard?	For secured cash flow lending (e.g. lending secured by a general charge over the business) we propose that APRA clarify that it is compliant with paragraph 47 if associated security valuations are assessed by an independent 2nd line function that is separate in terms of reporting lines and remuneration decisions from the 1st line commercial department that originated that lending. An example would be the valuation of collateral under a General Security Agreement. We believe the proposed approach is consistent with the intent of paragraph 47 (and draft APG 220 para 58) which is principally to avoid conflicts of interest that result in optimistic security values. A truly independent 2nd line risk management function

				should have no incentive to approve inflated valuations. Furthermore, this approach avoids unnecessary duplication and expense required to establish and maintain internal valuation units or obtain external valuations for all cash flow lending. This could also place ADIs at a competitive disadvantage to non-ADI wholesale lenders.
2	**Role of the Board and Senior Management**			

3	APG 220 para 16 and 18	The revised APS 220 clarifies APRA's expectations of the role of the Board of an ADI. In APG 220, these expectations are expanded on with guidance for how the APS 220 should be interpreted. The ABA's concern regarding paragraphs 16 and 18 are similar: the language used in the guidance goes beyond the requirements set by the prudential standards. The risk here is that the guidance sets an unnecessarily high standard of evidence compared to the proportionality of the inherent risk at stake. Paragraph 16 of APG 220 calls for the Board to '*sufficiently, actively and rigorously engage*' on credit risk issues. The ABA considers that this expectation goes beyond the APS 220 requirement for the Board to '*regularly challenge, seek assurance and evidence*' on similar topics contained in APS 220. Paragraph 18 also introduces a new concept not contained in the APS 220, whereby the Board is expected to be alert to '*credit deterioration and signs that there may be problems that senior management may not be raising with the Board*.'	Could APRA clarify in APG 220 that the standard of evidence kept by the Board should be reasonable and proportionate to the issue being raised?	We propose the following: Add clarification in APG 220 that the standard of evidence kept by the Board should be reasonable and proportionate to the issue being raised. Replace the words 'sufficiently, actively and rigorously engage' in paragraph 16 of APG 220 to 'regularly challenges, seeks assurance and evidence on credit risk issues.' Delete the sentence in paragraph 18 which establishes expectation that the Board be alert to 'credit deterioration and signs that there may be problems that senior management may not be raising with the Board'.
	Restructures			
4	Restructures	To **establish the probability of default for Performing**	What is the expectation upon ADIs in relation to the requisite scope of data	

		Restructures, data collection will be required in order to distinguish between the performance of performing restructures and those exposures which are in financial difficulty or hardship, which have not been restructured.	collection, i.e. in terms of timing (pre and post January 2022), and the timeframe over which data collection is to occur?	
5	APS220 12(c).	Hardship concessions and Consumer mortgages:	Whether loans in Hardship combined with a non-commercial concession (APG 223 98(b)), are automatically deemed as a 'non-performing' restructure per APS220 12(c). If not, and a restructured item is capable of being classified as 'performing', how are these to be managed in view that arrears cannot be frozen or re-aged, and there is a likelihood these may turn into 'non-performing' exposures.	
6	Para 12(c) Draft APG 220 Para 120-121	In the existing standard (Sep 2020) at Attachment A [29], reference is made in parts of [27] and [29] in respect to a concession being measured against *new facilities or new clients with <u>a similar risk or risk profile.</u>* The existing standard demonstrates a link between the concession itself, and a *similar* risk profile.	How is the '*customer in good standing*' test to be applied, per Draft APG 220 [120-121]. i.e. using the lens of the customer in financial difficulty, hardship or default, *<u>in comparison</u>* to a customer in good standing; or is this a stand-alone assessment of whether a certain type of concession would be applied to a customer in good standing ordinarily (to ANZ's point); or something other. Whether this a two-limb test: 1) customer either in financial difficulty,	Further clarification of the approach to a restructure classification is required in APG 220. Based on the *customer in good standing* approach and without reference to a similar risk profile of the customer, this will result in a negligible number of performing restructures. This raises the question of what the

		For the incoming standard (Jan 2022), the Draft APG 220 at [120]-[121] impliedly indicates that there is no connection made with a similar risk profile or any other matter, by a stand-alone assessment of whether the concession would be offered to a customer in good standing. Because the majority of the concessions listed at 12(c)(ii) are appropriate to performing restructures and are also available to a customer in good standing, this means that without a connection to a similar risk profile of the customer (as in the current standard), there will be very few which will qualify as a restructure. And many of these concession types would also not apply to a non-performing exposure.	hardship, or default, and 2) whether the concession would be ordinarily available to the risk profile of the customer in their current position (where they are in financial difficulty hardship or default). The introduction of the customer in good standing test suggests this is a three-limb test. *The above excludes scenarios covered by [101] which are not treated as restructures.	introduction of performing restructures is intended to achieve.
	Non-Performing Exposures			
7	APS 220 94(c)	To reclassify from a non-performing exposure to a performing exposure, APS 220 has changed from '*forming a view*' to a '*full repayment is likely*' assessment at 94(c), notwithstanding the addition of a continuous repayment period of 90days at 94(b).	What is the expectation on ADIs in relation to the assessment of 94(c), to determine whether the borrower's situation has improved so that full repayment is 'likely'. whether this can be assessed using internal information alone, in the context of volume markets.	
8	APS 220 12(a)(ii) and 94(b)	Where the **timeframe stipulated is 90 days**, can this time frame be treated as 3 months, or 3 payment	Can this time frame be treated as 3 months, or 3 payment cycles, or must	

Australian Banking Association

		cycles, or must this be treated as strictly 90 calendar days? This creates a new and second trigger to exit non-performing. It changes from a spot trigger in isolation, to a spot trigger plus a second trigger at 90days.	this be treated as strictly 90 calendar days? System impacts are considered significant which will present inconsistencies and challenges to regulatory and financial reporting given the difference in definition.	It is proposed that the 90day period can also be treated as 3 months or 3 monthly payment cycles, at the discretion of the ADI.
9	APS 220 at 94(a)	**Reclassification requirements** in APS 220 at 94(a) where the borrower must not have an exposure more than 90 days past due, and 94(b) where a continuous repayment period of 90 days is required before a non-performing exposures can be reclassified as performing.	Would arrears continue to accrue on the original scheduled payments as is the case in APG 223 at 98(a) for hardships.	
10	APS 220 12(a)	In the case of subsidiaries operating in jurisdictions where the local definition of default is different to that of APS 22012(a), and the local definition is more conservative.	Can the ADI opt to adopt APS 220 over their local regulation, and vice versa?	It is proposed that the subsidiary adopt its local regulation, at the discretion of the ADI.
11	12(a)(ii)	In 12(a)(ii) it is stated that if the number of days past due is different in a subsidiary's jurisdiction, the number of days can be applied according to the local jurisdiction for individuals and public sector entities.	Does this relate only to the number of days, to the exclusion of other aspects of the definition of default? For example, does this apply to the 'value' hurdle in addition to the number of days – APS 220 12(a)(ii) requires that a two-limb hurdle be met: Time (90days) <u>AND</u> Value (90day's worth of payments).	It is proposed that the subsidiary adopt its local regulation, at the discretion of the ADI.

			Reserve Bank of NZ Capital Adequacy Framework (BS2B) at 4.268 requires a one limb hurdle be met: Time (90 days) OR Value (90s day's worth of payments). Customers who are not individuals or public sector entities will not invoke the above jurisdictional flexibility in 12(a)(ii) – are there any exceptions or circumstances where this may differ?	
12	12(a)	Drafts APS 112 at [13] and APS 113 at [13] state that a subsidiary prudentially regulated in New Zealand must have Level 2 regulatory capital calculated using the local methodology for RWA and EL. Of relevance is the proposed effective date for APS 112 and APS 113 is not until 2023.	What are the implications of the proposed arrangements against APS 220 in general, in terms of allowing NZ subsidiaries to operate under RBNZ regulatory requirements more broadly?	(Open Question)
13	APS 220 12(a) and APS 112 / 113; more broadly APS 220 as a whole	APS 220 will be effective January 2022 (or sooner), whereas the Basel III revised APS 112 and APS 113 standards are effective January 2023. This presents a timeline gap in relation to management of the revised definition of and requirements for 'default'.	What are the expectations upon ADIs to manage the timeline gap between implementation of APS 220 and the implementation of APS 112 and APS 113, given the following factors for consideration: Existing APS 112/113 calculations and models work on the current definition of default. To rebuild, this will amount to a significant resource outlay not otherwise anticipated.	(Open Question)

Australian Banking Association

			The change to the definition of default in APS 220 will require recalibration and potential rebuild of a significant number of models currently in production (and embedded rules), requiring approval from APRA	
14	Valuations (Attachment A in general, and para A13)	Further to previous question, and in the context of valuation requirements, APS 220 does not provide for any special rules relating to subsidiaries in other jurisdictions.	Whether there is scope for subsidiaries in other jurisdictions to adopt local regulatory requirements in relation to valuations (ie in NZ the regulation of RBNZ) Where unique jurisdictional circumstances may prevent APS 220 being complied with, but local regulatory requirements can be complied with, whether this may influence the approach to question a) above. This is particularly relevant in small jurisdictions.	It is proposed that the subsidiary adopt its local regulation, at the discretion of the ADI.