Australian Banking Association

**6 July 2022**

Thank you for the time APRA made available to update ABA member regarding the potential final settings in a number of prudential practice guides for the revisions to the capital standards. We appreciate the consideration APRA has given to ABA feedback, particularly in the changes to the treatment of domestic infrastructure, property backed guarantees and the pragmatic implementation of the 5 or more mortgaged investment properties policy setting. The ABA notes there is still some refinement of wording and other processes which APRA seek to work through as they aim for a July release of the final PPGs.

The ABA takes this opportunity to provide feedback on the proposed policy settings contained in the slides presented at the ABA workshop on 27 June 2022.

To assist, we have also reattached our ABA letter of 31 May 2022 titled: *Pragmatic implementation of APG 110, APG 112 and APG 113.*

## SME definition (slide 6)

**SME definition & Determination of Turnover limited to where there is recourse**

As highlighted by the ABA in our 31st May 2022 letter and in the subsequent ABA APRA workshop 27th June 2022, the ABA requests that APRA consider limiting measurement of firm-size to entities to which an ADI has recourse. While APRA indicated clarification will be provided through Prudential Practice Guides, ABA continues to highlight the material operational challenges and the inappropriate application of FIRB large corporate measurement parameters where accounting consolidation is applied in circumstances with limited or no recourse.

In addition to firm-size SME measurement, the ABA notes:

- ADIs may not be able to access consolidated financial statements (or various entities) where there is no recourse to an entire consolidated group of a borrower (or related-party guarantors).
- Assessment of large corporate creditworthiness will typically be limited to financial statements of entities to which the ADI has recourse with financial information used in determination of PD ratings.
- Infrastructure (and similar) structures may be subject to ‘ring fenced’ revenues.

Therefore, the ABA view is that:

  - large corporate measurement should consider revenue based on recourse, not the entire consolidated/aggregated group that have no direct relationship with serviceability assessment or PD assignment.
  - Where there is an eligible guarantor (i.e., parent (or similar) guarantee of the borrower but excluding credit insurer or Export Credit Agency), use of guarantor revenue is appropriate for large corporate measurement. Any other consolidation of revenues to measure large corporate without connection to recourse results in a measurement disconnected with underlying transaction structure.
  - ADIs should not consolidate the revenue of shareholders without recourse (e.g., ADI financing infrastructure asset owned by a superannuation fund) in the assessment of creditworthiness and assignment of PD and LGD ratings to the borrower

**ABA recommendation**

- Given operational challenges associated with obtaining consolidated financial statements and inaccurate assessment of large corporate measurement, the ABA proposes consolidated annual revenue of entities to which an ADI has recourse should be utilised in determining asset class under APS 112 and APS 113 – noting that this approach also aligns with financial information utilised in origination processes, including assignment of PD estimates.

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## 5 or more mortgaged investment properties (slide 7)

APRA has provided guidance that borrowers that have mortgaged 5 or more investment properties would be treated as IPRE with the following revised treatment:

- Application of a 2.5 scalar within the residential mortgage asset class, allowing for use of existing retail models and maintaining the retail treatment of customers;
- Guidance to monitor retail borrowers with multiple investments and have criteria in place to treat them as corporate where appropriate;
- As a transitional arrangement, exposures originated or refinanced before 1 January 2023 may receive the 2.5 scalar to the subset of borrowers with 5 or more investment properties where all properties are mortgages with the ADI (rather than to other lenders).

ADIs will endeavour to implement this new requirement into the capital calculations from 1 January 2023, but given challenges with data in the back-book and the tight implementation timeframes, ADIs would seek a pragmatic approach from APRA for the first 12 months until 1 January 2024. ADIs and APRA could then re-evaluate the data and implementation approach throughout 2023.

**ABA recommendation**

To support a consistent adoption across industry, the ABA proposes the following:

1) To determine the population that is eligible for the 2.5 scalar, ADIs will only capture:

   a) mortgaged properties where the predominant purpose is for investment; and

   b) where prospects for debt servicing and repayment depend primarily on cash flows generated by real estate (i.e. where >50 per cent of the repayment is from rental income); and

   c) the borrower has mortgaged more than four housing units (excluding the borrower's primary residence). This would be obtained at origination or refinancing and updated on a best endeavours basis.

For avoidance of doubt, a customer with more than 5 investment properties where the primary cash flows for repayment is not dependent on the cash flows generated by the real estate will not be captured in the population eligible for the 2.5 scalar.

2) To count the number of properties, ADIs will endeavour to use a borrower-based approach as outlined in the draft APG 113. On this basis, a customer that has a joint loan or a loan linked as part of a trust arrangement will not have properties aggregated with those of the joint loan or trust. These will be captured separately (see example below). ADIs will count the number of properties:

   a) By collateral, if available;

   b) By loan, (if collateral data not available). Some allowance will need to be made in the calculation where there are identified split loans to avoid double counting.

3) ADIs will aggregate across brands/entities within the broader ADI group on a best endeavours basis only. Where a customer cannot be linked across brands, the counting of properties will be based on the customer identification within a single brand or entity only.

ADIs see this as the simplest and most pragmatic method of being able to deliver consistent estimates for this segment on 1 January 2023. A simple depiction of the above is represented below:

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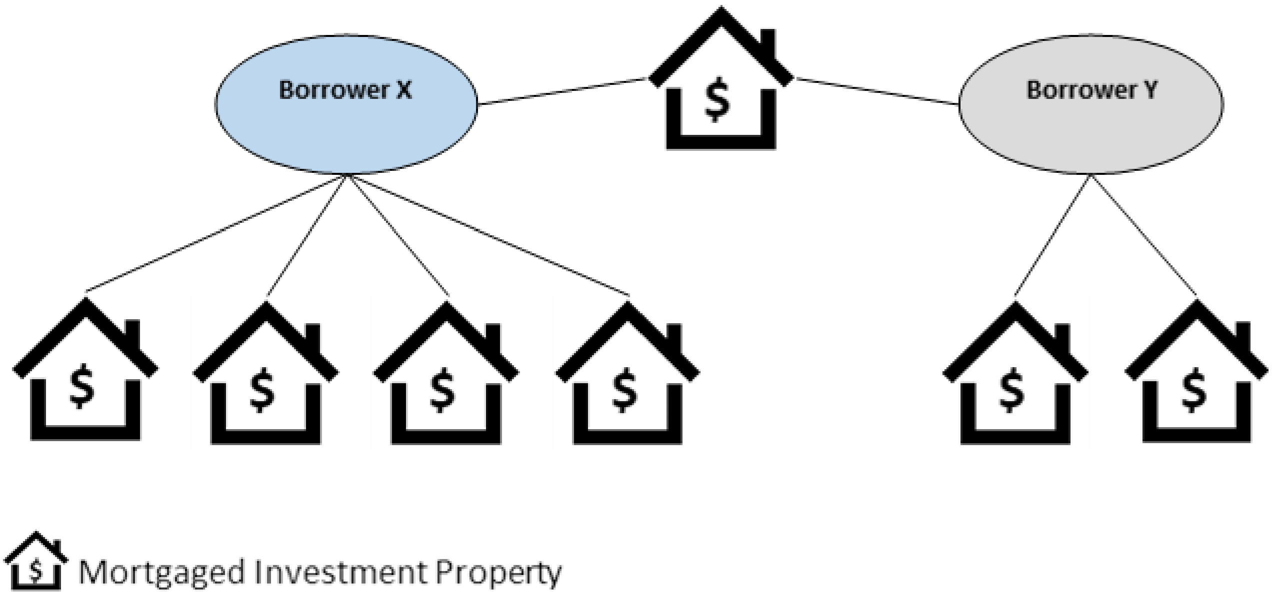
**Figure 1: Calculation method for 5 or more mortgaged investment properties**




<table>
<tr><th></th><th>Borrower Y</th><th>Borrower Y</th><th>Borrower X & Y (joint loan)</th><th>Total</th></tr>
<tr><td>Total number of collaterals</td><td colspan="4" align="center">7</td></tr>
<tr><td>Borrower</td><td>4</td><td>2</td><td>1</td><td>7</td></tr>
</table>

## Comparable direct exposures (slide 9)

We refer to our letter of 31 May 2022 “Pragmatic implementation of APG 110, APG 112 and APG 113”, where the ABA responded to APRA’s ‘Indicative views on guidance’, dated 27th April. We would like APRA to reconsider their current interpretation of Comparable Direct Exposure based on the points we raised in our 31 May letter and the following additional analysis.

**Currently:**

ADIs provide funding to customers that benefit from collateral provided by the obligor and a guarantee from an eligible guarantor.

Typical examples would be:

- ADIs providing a secured asset finance facility to a company together with an eligible guarantor;
- Capital management initiatives involving Export Credit Agencies, Insurance or similar.

In these situations, the ADI has collateral (the assets being financed) and an unsupported guarantee from an eligible guarantor and has historically recognised both mitigants independently in determining the LGD and PD for the exposure.

However, the proposed APRA comparable direct exposure policy setting means that an ADI must not recognise the collateral provided by the obligor if the guarantee support is recognised, as the collateral has not been provided by the guarantor.

The ABA disagrees with this interpretation and the current APRA policy position may result in counter-intuitive outcomes. If the collateral provided by the obligor is not recognised in determining the LGD, the RWA and EL will be overstated and customers will rightly question the value of providing collateral if they receive no pricing benefit relative to unsecured borrowing.

**The comparable direct exposure policy setting and its interpretation**

The new APS 113, Att B paragraph 49 says:

> Para 49: **The application of CRM in the form of guarantees and credit derivatives** must not reflect the effect of double default nor result in an adjusted risk weight that is less than that of a comparable direct exposure to the guarantor or credit protection provider.

This mirrors the Basel III requirement in relation to the nature of the CRM. The bolded wording above makes it clear the rule applies to guarantees and credit derivatives only, not CRM generally. APS 113 paragraph 14 (g) defines CRM as also including collateral.

The ABA view is that the rule has been interpreted too broadly by APRA in that APRA now applies the rule to all CRM, including overriding where there is also CRM in the form of collateral provided by an obligor. This interpretation of the rule ignores the context of the rule which should correctly apply when there is only CRM in the form of guarantees/credit derivatives. This is the essence of the "comparable direct exposure" - it is only in the situation where there is only guarantee support that a blanket cap of the guarantor's risk weight is sound. However, the rule appears to have been interpreted to apply to all CRM so collateral already provided by an obligor for a guaranteed exposure must be de-recognised.

If this was the intent, a clear and corresponding LGD rule which says collateral should be derecognised where there is PD uplift provided by a guarantee would be expected.

**The comparable direct exposure policy setting and conflicts with other policy settings**

Not only is there no such clear and corresponding rule in the collateral and LGD sections, but paragraph 16 in the new APS 113 Att E provides:

- In adjusting PD or LGD estimates to reflect the impact of guarantees and credit derivatives, an ADI must take all relevant, material information into account.

Where a guaranteed exposure has both eligible collateral provided by the obligor and a guarantee, both are clearly relevant and material to the PD and LGD. The collateral directly affects the LGD and the guarantee directly affects the PD.

Unlike paragraph 49 (which deals with guarantee/credit derivative support and does not mention collateral), paragraph 16 explicitly deals with what to do where CRM in the form of guarantee/credit derivative support and collateral are present. This rule is therefore more relevant to the customer situation raised above.

**ABA recommendation**

Both paragraphs 49 and 16 are "must" rules – an ADI must comply with both so there must be a way for ADIs to comply with them simultaneously.

In its context, the comparable direct exposure rule clearly relates to CRM provided by a guarantee or credit derivative only and not to collateral provided by the obligor. The guarantee rules in paragraphs 47-54 of the new APS 113 Att B do not address where there is a both guarantee <u>and</u> collateral.

- Where the only CRM is a guarantee, capping the PD uplift of the guaranteed portion to the PD of the guarantor is logical. There is no additional loss mitigant and following a default by the obligor the recourse is just to the guarantor.
- However, it is not logical where there is additional CRM. In this situation, there is an additional loss mitigant that is both relevant and material.

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Rather than interpreting paragraph 49 as prohibiting PD and LGD uplift in all circumstances and overriding paragraph 16 (without this being explicitly provided), the way both rules can work simultaneously is to recognise that CRM has two components and apply the APS 113 guarantee rules and the APS 113 collateral rules separately in sequence:

- The guarantee uplift rules which would cap the uplift at the guarantor's PD.
- The collateral rules (Att B, paras 14-21 and Att E for eligibility) which separately calculate LGD. Where there is eligible collateral held for an exposure, the LGD should reflect this.

This would mean that K and EL for the exposure would correctly reflect the risk. Allowing the collateral to flow through to the final LGD is consistent with letting the underlying maturity flow through which is allowed under paragraph 50 in the new APS 113 Att B.

## Consequential amendments consultation (slide 11)

**NSFR**

The ABA welcome APRA's proposed changes to NSFR to remove the main dependency to the changes in the revised Standardised approach under the new capital framework noting that there remains some dependency in relation to additional references to APS 112 classifications. Additionally, the ABA would propose APRA align the definition of commitments in APS210 to the revised APS112 so they are only recognised at the point of acceptance by the borrower for the purpose of the LCR calculation.

As discussed in the meeting, the ABA would appreciate a formal consultation on any proposed amendments to APS 210 to understand the intent and impact on both the NSFR and LCR allowing sufficient implementation time.

**Treatment of New Zealand exposures**

The ABA is keen on getting further details on the APS 120 (Securitisation) and APS 180 (Counterparty Credit Risk) changes APRA is proposing to accommodate the differences in RBNZ rules for New Zealand subsidiaries. The ABA would be supportive of changes that would make the implementation simpler for investors and shareholders to understand and for ADIs to implement i.e. consistent adoption of either the APRA or RBNZ standards. We look forward to the formal consultation with APRA on the changes.

## Proxies

**Approval process for proxies**

We refer to our letter of 31 May 2022 "Pragmatic implementation of APG 110, APG 112 and APG 113", where the ABA responded to APRA's 'Indicative views on guidance', dated 27th April. The ABA would welcome APRA's views on the proxy approaches detailed in our letter, in particular the Appendices C through H.

We seek these APRA's views, as the ABA is assuming that ADIs would need to reference them in their applications to APRA per the indicative tiering approach (slide 13) presented at the ABA workshop on 27 June. It would be useful to know if APRA has concerns ahead of ADIs submitting their proposals.

**Timelines**

The ABA agrees in principle with APRA's suggested tiering and materiality thresholds for proxy approval process. ABA members intend to make proxy submissions in line with APRA's timelines. However, the complexity of data capture, piping, systems and calculations tasks ahead for each ADI necessitates a flexible approach. In particular, as data is piped through product systems to land in regulatory calculation engines, further proxies will be needed based on data linkage and quality checks, and potential defects that may be identified in the process, e.g. on turnover as ADIs set up data capture for new parts of the portfolio. Such issues will surface at different times depending on various data flows leading into and even after the parallel runs. It is therefore essential that APRA, acknowledges the possibility of some proxies landing late in the process, and most importantly, adopts an approach that permits the inclusion of these proxies into its assessment.

This approach would be in line with the ethos of pragmatic implementation and would give ADIs the flexibility needed in what is a very challenging implementation timeline.

## Conclusion

We again note the considerable efforts of the APRA team to finalise the revisions to the capital framework and their work with ADIs to minimise unnecessary regulatory burdens in implementation. If you require further information or would like to discuss any of the content of this letter, please do not hesitate to contact me on 0447 795 827 or aidan.oshaughnessy@ausbanking.org.au .