

Banking (prudential standard) determination No. 3 of 2020

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Banking Act 1959, section 11AF

Under subsection 11AF(1) of the *Banking Act 1959* (the **Act**), APRA has the power to determine standards (**prudential standards**), in writing, in relation to prudential matters to be complied with by authorised deposit-taking institutions (**ADIs**) and authorised non-operating holding companies (**authorised NOHCs**). Under subsection 11AF(3) of the Act, APRA may, in writing, vary or revoke a prudential standard.

On 27 February 2020, APRA made Banking (prudential standard) determination No. 3 of 2020 (the instrument), which revokes *Prudential Standard APS 220 Credit Quality* made under Banking (prudential standard) determination No. 8 of 2014 and determines *Prudential Standard APS 220 Credit Risk Management* (APS 220).

The instrument commences on 1 January 2021.

1. Background

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system.

APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of institutions. In the case of the banking industry, APRA is empowered under the Act to issue legally binding prudential standards that set out specific prudential requirements with which ADIs must comply. These standards are supported by prudential practice guides (PPGs), which clarify APRA's expectations with regard to prudential requirements.

APRA regularly reviews its regulatory regime and amends its prudential requirements as a result of a number of factors including:

- international developments;
- changes in financial market conditions or changes in risk management practices, in response to identified weaknesses in the prudential framework; and
- to reduce potential negative impacts of emerging industry issues.

One of the key components of APRA's prudential framework is the prudential standard that relates to an ADI's credit risk management.

Prudential Standard APS 220 Credit Quality requires an ADI to control credit risk by adopting prudent credit risk management policies and procedures. These policies and procedures must apply, in particular, to the recognition, measurement and reporting of, and provisioning for, impaired exposures (e.g. bad loans).

While financial institutions have faced difficulties over the years for a multitude of reasons, a major cause of banking problems globally continues to be related to lax credit standards for

borrowers, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's borrowers.

Credit risk is most simply defined as the potential that a borrower will fail to meet its obligations in accordance with agreed terms. ADIs need to manage the credit risk inherent in the entire credit portfolio as well as the credit risk in individual exposures or transactions. ADIs also need to consider the relationships between credit risk and other risks they may face. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term safety and soundness of an ADI.

For most ADIs, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of an ADI, including in the banking book and in the trading book. ADIs may face credit risk in various financial instruments other than loans, including acceptances, inter-bank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.

Prudential Standard APS 220 Credit Quality has not had a significant update since 2006 and there is a need to modernise the standard. While the standard covers classification of exposures and provisioning requirements in detail, there is less emphasis on credit standards, and the on-going monitoring and management of an ADI's credit portfolio over the full credit life cycle (this cycle starts with the first contact with a potential borrower and continues through to their final payment). Over time, credit risk management practices have also evolved to include more sophisticated analytical techniques and information systems.

APRA has observed deficiencies in credit risk management. APRA's supervisory review of residential mortgage exposures revealed, for example, concerns regarding many ADIs' assessments of potential borrowers' ability to service a loan. As part of its work on residential mortgage lending, APRA also highlighted the importance of Board oversight of evolving risks, including the need for increased Board understanding and monitoring of risks within the credit portfolio.¹

APRA's recent review of commercial property lending practices also noted an erosion of credit standards due to competitive pressures. The ability of the Board and senior management of an ADI to fully understand and challenge the risk profile of lending have often been hampered by inadequate data, poor monitoring and incomplete portfolio controls.²

Credit standards are critical in driving credit quality, yet best practice expectations on credit risk management (including the outcomes of APRA's recent reviews of credit standards) are largely absent from *Prudential Standard APS 220 Credit Quality*. Although APRA's previous pronouncements on credit risk remain relevant, these APRA letters and prudential practice

¹ APRA Letter: *Reinforcing sound residential mortgage lending practices*, 9 December 2014; APRA Letter: *Further measures to reinforce sound residential mortgage lending practices*, 31 March 2017; and APRA Letter: *Embedding sound residential mortgage lending practices*, 26 April 2018. APRA letters are available on APRA's website.

² APRA Letter: *Commercial property lending - thematic review considerations*, 7 March 2017.

guides (i.e. *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223)) do not create enforceable requirements.³

The final report of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* also identified a range of areas where the regulation and supervision of financial institutions should be strengthened.

In particular, the Royal Commission recommended that APRA amend *Prudential Standard APS 220 Credit Quality* to require that internal appraisals of the value of land taken or to be taken as security by ADIs should be independent of loan origination, loan processing and loan decision processes; and provide for valuation of agricultural land in a manner that will recognise, to the extent possible: the likelihood of external events (e.g. drought, fire and flood) affecting its realisable value; and the time that may be taken to realise the land at a reasonable price affecting its realisable value.⁴ The prudential standard needs to be updated to include the recommendation relevant to the standard regarding the valuation of collateral taken by ADIs.

Further, *Prudential Standard APS 220 Credit Quality* does not reflect recent international supervisory guidance on two important definitions of credit quality, namely “non-performing exposures” and “forbearance”. The definitions promote harmonisation in the measurement and application of credit quality, thereby fostering consistency and comparability in supervisory reporting.⁵

Australian Accounting Standard AASB 9 Financial Instruments (AASB 9) applies for reporting periods beginning on or after 1 January 2018. AASB 9 provides for a forward-looking and expected loss approach to provisioning for credit losses whereas the previous accounting standard provided for an incurred loss approach.⁶ *Prudential Standard APS 220 Credit Quality* is out of date in this area, as it reflects concepts and terminology commensurate with an accounting incurred loss approach.

2. Purpose and operation of the instruments

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The purpose of the instrument is to revoke *Prudential Standard APS 220 Credit Quality* and to replace it with a new version of the standard. The new version of the standard has been

³ *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223) is available on APRA’s website.

⁴ Recommendation 1.12 - Valuations of land, *The Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*. The Final Report is available on the Treasury website.

⁵ *Basel Committee guidance on the prudential treatment of problem assets - definitions of non-performing exposures and forbearance, April 2017*. Basel Committee guidance is available on the Bank for International Settlements website.

⁶ AASB 9 applies for reporting periods beginning on or after 1 January 2018 and replaced *AASB 139 Financial Instruments: Recognition and Measurement* (AASB 139).

renamed *Prudential Standard APS 220 Credit Risk Management* to better reflect the focus of the standard.

Where APS 220 refers to an Act, Regulation or prudential standard, this is a reference to the document as it exists from time to time, and which is available on the Federal Register of Legislation at www.legislation.gov.au.

APS 220 provides for APRA to exercise various discretions. Decisions made by APRA exercising those discretions are not subject to merits review. This is because these decisions are preliminary decisions that may facilitate or lead to substantive decisions which are subject to merits review.

A breach of a prudential standard is a breach of the Act, as section 11AG of the Act provides that ADIs must comply with applicable prudential standards. However, there are no penalties prescribed for breach of a prudential standard. Instead, an ADI's breach of a provision in the Act is grounds for APRA to make further, substantive decisions under the Act in relation to the ADI. Those decisions are:

- (a) to revoke an authority to carry on banking business (section 9A of the Act); and
- (b) to issue a direction to the ADI, including a direction to comply with the whole or part of a prudential standard (section 11CA of the Act).

It is only at this stage that an ADI is exposed to a penalty: loss of its authority under section 9A or 50 penalty units if it breaches the direction (section 11CG of the Act). The subsequent substantive decisions by APRA to impose a direction or revoke an authority are subject to merits review. In nearly all cases⁷ the decision is preceded by a full consultation with the ADI to raise any concerns it may have in relation to the decision.

3. Consultation

APRA has undertaken public consultation in revising its credit risk management framework. In March 2019, APRA released a Discussion Paper and draft revised prudential standard outlining the key proposals.⁸

APRA received fifteen submissions to its proposals. Submissions were broadly supportive of the proposed reforms. However, some submissions sought clarification of the role of the Board and senior management in credit risk management and the application of the proposed credit standards for certain types of lending. Respondents also raised issues regarding the proposed valuation of collateral and asset classification requirements.

⁷ Subsection 9A(4) of the Act specifically provides that APRA does not need to consult where APRA is satisfied that doing so could result in a delay in revocation that would be:

- (a) contrary to the national interest; or
- (b) contrary to the interests of depositors with the ADI.

⁸ APRA Discussion Paper *APS 220 Credit Risk Management, March 2019* is available on APRA's website.

APRA amended its initial proposals in a number of areas following consideration of the issues raised in submissions.⁹

Information concerning consultation on the making of the instrument is contained in APRA's discussion and response to submissions papers.

It is important to financial safety and financial stability that ADIs adopt prudent credit standards and are appropriately managing credit risk over the full credit life cycle. The final revised APS 220:

- includes best practice credit risk management expectations, including prudent credit standards and the Royal Commission recommendation relevant to APS 220 regarding the valuation of land;
- reflects concepts and terminology commensurate with the new accounting standard AASB 9; and
- provides a consistent basis for international comparison of ADIs' credit risk.

4. Regulation Impact Statement

APRA undertook an independent review of revisions to the credit risk management framework and has followed a process and analysis equivalent to a Regulatory Impact Statement (RIS). Regulatory costs detailed in the RIS were agreed with the Office of Best Practice Regulation.

The documents evidencing this process (i.e. contained in the APRA discussion and response to submissions papers) have been lodged as supporting material.

5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

A statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

⁹ APRA Response to Submissions Paper *APS 220 Credit Risk Management, December 2019* is available on APRA's website.

ATTACHMENT A

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

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The legislative instruments are compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

Overview of the Legislative Instruments

The purpose of the instrument is to revoke *Prudential Standard APS 220 Credit Quality* determined by APRA in 2014; and replace it with a new *Prudential Standard APS 220 Credit Risk Management*.

The new APS 220 replaces the previous APS 220 to: include best practice credit risk management expectations, including prudent credit standards; include the Royal Commission recommendation relevant to APS 220 regarding the valuation of land; reflect concepts and terminology commensurate with the new accounting standard AASB9; and provide a consistent basis for international comparison of ADIs' credit risk.

Human rights implications

APRA has assessed the instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instrument is compatible with human rights.

Conclusion

The instrument is compatible with human rights as it does not raise any human rights issues.