

## **Banking (prudential standard) determination No. 4 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 7 September 2020, APRA made Banking (prudential standard) determination No. 4 of 2020 (the instrument), which revokes *Prudential Standard APS 220 Credit Risk Management* made under Banking (prudential standard) determination No. 3 of 2020 and determines *Prudential Standard APS 220 Credit Quality* (APS 220).

The instrument commences upon registration on the Federal Register of Legislation.

#### **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 gives effect to its mandate by establishing minimum expectations for prudentially regulated financial institutions. In the banking industry, the Act allows APRA to issue legally binding prudential standards that set out specific prudential requirements with which ADIs and authorised NOHCs must comply.

A key component of APRA's prudential framework for ADIs is the prudential standard for credit risk management. Credit risk means the risk that a borrower will fail to meet its obligations in accordance with agreed terms. ADIs need to manage the credit risk of exposures to individual borrowers, as well as their loan portfolios as a whole. The effective management of credit risk is critical to the long-term financial safety of an ADI.

APS 220 requires an ADI to control credit risk by adopting prudent credit risk management policies and procedures. These policies and procedures must be applied to the recognition, measurement and reporting of, and provisioning for, impaired exposures (e.g. bad loans).

To measure impaired exposures, ADIs must classify their loans as either performing or non-performing. A loan must be classified as non-performing where the borrower is 90 days past-due, or the ADI determines that they are otherwise unlikely to repay due to, for example, write-offs or insolvency. Where an ADI has restructured an exposure – that is, it has modified the original terms and conditions of the loan due to borrower hardship – APS 220 requires that the loan must perform in accordance with the revised terms and conditions for a period of at least six months, before it can be returned to a non-impaired status. ADIs must hold additional regulatory capital for impaired loans.

In response to the unprecedented economic challenges presented by the COVID-19 pandemic, ADIs have offered large numbers of borrowers repayment deferrals or otherwise modified the terms of loans. While APS 220 details the prudential treatment of loan deferrals and restructures, the economic environment created by COVID-19 is not contemplated within the standard.

## **2. Purpose and operation of the instrument**

The purpose of the instrument is to revoke *Prudential Standard APS 220 Credit Risk Management* made under Banking (prudential standard) determination No. 3 of 2020, and replace it with a modified version of the standard. The changes to the standard are limited to a new Attachment E to the standard, which will operate on a temporary basis until 31 March 2021. From 1 April 2021, ADIs will be required to revert to applying the existing standard requirements to all loans; however, this does not prevent or preclude ADIs from continuing to provide repayment deferrals or other types of restructures to borrowers where required.

The new Attachment E to APS 220 temporarily adjusts the prudential treatment for loans granted repayment deferrals, or that are otherwise restructured, due to COVID-19. Where an ADI provides an eligible borrower with a repayment deferral, it does not need to classify the loan as restructured, and may pause the counting of days past-due, so as not to trigger the requirement to classify the loan as impaired. Further, where an ADI restructures a loan to an eligible borrower, it may immediately return the loan to a non-impaired status, without the loan first needing to have performed in accordance with the revised terms and conditions for six months. The effect of these changes is to reduce the amount of regulatory capital that ADIs would otherwise have to hold against these exposures.

APRA considers that the temporary adjustments to the existing standard are appropriate in response to the COVID-19 pandemic. The changes are intended to provide ADIs with greater flexibility in supporting borrowers through the COVID-19 pandemic. The instrument does not trespass on personal rights or liberties, or amend or modify the operation of primary legislation.

Where APS 220 refers to an Act, Regulation, prudential standard or Australian Accounting Standard,<sup>1</sup> 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](http://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

---

<sup>1</sup> Australian Accounting Standards is defined in *Prudential Standard APS 001 Definitions* as the Australian Accounting Standards issued by the Australian Accounting Standards Board as may be amended from time to time.

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 of APRA to impose a direction or revoke an authority are subject to merits review. In nearly all cases,<sup>2</sup> the decisions are preceded by a full consultation with the ADI to raise any concerns it may have in relation to the decision.

### **3. Consultation**

APRA engaged in a short one-week public consultation on the proposed temporary adjustments to the prudential treatment of loans impacted by COVID-19 under the existing standard prior to amending the standard.<sup>3</sup> APRA received seven submissions on its proposals from industry associations and ADIs.

Respondents were broadly supportive of APRA's proposal to formalise previously announced measures through temporary adjustments to the existing standard. Respondents requested that APRA provide some additional flexibility in the application of the temporary measures, particularly the treatment of restructures and counting of arrears, in light of the continued uncertainty about future lockdowns or restrictions on activity. In response, APRA has provided some additional flexibility by removing the requirement that loans may only be restructured once, and clarifying that arrears counts may be reset to zero where the ADI modifies the loan to adjust for any previous missed payments.

Respondents also sought further clarification on the scope of loans eligible for the temporary treatment. Consistent with earlier communications, APRA has limited eligibility to natural persons and small businesses with less than \$10 million in total debt facilities outstanding. Minor amendments to the drafting of the relevant provision were also made to clarify that exposures to other legal entities are also eligible where the relevant criteria are satisfied.<sup>4</sup>

---

<sup>2</sup> 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 contrary to the national interest or the interests of depositors with the ADI.

<sup>3</sup> The consultation letter is available on APRA's website at <<https://www.apra.gov.au/treatment-of-loans-impacted-by-covid-19>>.

<sup>4</sup> APRA's full response and non-confidential submissions are available on APRA's website at <<https://www.apra.gov.au/treatment-of-loans-impacted-by-covid-19>>.

#### **4. Regulation Impact Statement**

The Office of Best Practice Regulation has advised that no Regulation Impact Statement is required as the changes are minor and machinery (Reference ID 42816).

#### **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.

## ATTACHMENT A

### **Statement of Compatibility with Human Rights**

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

#### **Banking (prudential standard) determination No. 4 of 2020**

The instrument is 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 instrument**

The purpose of Banking (prudential standard) determination No. 4 of 2020 is to revoke *Prudential Standard APS 220 Credit Risk Management* made under Banking (prudential standard) determination No. 3 of 2020 and replace it with a new *Prudential Standard APS 220 Credit Quality* (APS 220). The changes incorporate temporary prudential treatments for loans with repayment deferrals or that are otherwise restructured due to the COVID-19 pandemic. The changes are limited to imposing obligations on ADIs.

#### **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.