

Banking (prudential standard) determination No. 1 of 2021

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 25 August 2021, APRA made Banking (prudential standard) determination No. 1 of 2021 (the instrument), which revokes *Prudential Standard APS 220 Credit Quality* made under Banking (prudential standard) determination No. 4 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 quality. Credit risk is 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. ADIs must hold additional regulatory capital for impaired loans.

In response to the unprecedented economic challenges presented by the COVID-19 pandemic, a number of ADIs have announced COVID-19 support packages that will

provide affected borrowers with an option to defer their loan repayments. These packages have been offered to small business, home loan and other retail customers.

In September 2020 APRA made Banking (prudential standard) determination No. 4 of 2020 to provide temporary concessional treatment for loans granted repayment deferrals or restructures due to COVID-19. The temporary treatment applied to the period 23 March 2020 to 31 March 2021. Attachment E to the new APS 220 replaces the previous Attachment E in order to provide temporary concessional treatment for the latest round of support packages.

2. Purpose and operation of the instrument

The purpose of the instrument is to revoke *Prudential Standard APS 220 Credit Quality* made under Banking (prudential standard) determination No. 4 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 December 2021. In the absence of an extension of the modifications, from 1 January 2022, 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. For eligible borrowers, ADIs will not need to treat a repayment deferral as a loan restructuring or the period of deferral as a period of arrears.

The proposed amendments to APS 220 cover repayment deferrals granted on or after 8 July 2021 and will apply to loans that are granted a repayment deferral of up to three months on or before 30 September 2021, whether or not the borrower has previously been granted a repayment deferral. ADIs must still continue to provision for these loans under relevant accounting standards. The effect of these changes is to reduce the amount of regulatory capital that ADIs would otherwise have to hold against these exposures.

APS 220 has also been amended to provide APRA with the flexibility to extend the timing and operation of the temporary capital treatment where necessary and as relevant circumstances evolve.

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,¹ this is a reference to the document as it exists from time to

¹ 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.

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 of APRA to impose a direction or revoke an authority are subject to merits review. In nearly all cases,² 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 urgently 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.³ APRA received five 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.⁴

4. Regulation Impact Statement

The Office of Best Practice Regulation has advised that no Regulation Impact Statement is required as it is unlikely to have a more than minor regulatory impact. (Reference ID 44272).

² 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.

³ The consultation letter is available on APRA's website at [Consultation on loans impacted by COVID-19: Regulatory support | APRA](#).

⁴ APRA's full response and non-confidential submissions are available on APRA's website at: [APRA releases response letter on its proposed treatment of loans impacted by COVID-19 | APRA](#)

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*

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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. 1 of 2021 is to revoke *Prudential Standard APS 220 Credit Quality* made under Banking (prudential standard) determination No. 4 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.