

Banking (prudential standard) determination No. 1 of 2024

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 August 2024, APRA made Banking (prudential standard) determination No. 1 of 2024 (the instrument), which revokes *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* made under Banking (prudential standard) determination No. 6 of 2022 and determines a new *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112).

The instrument commences on 30 September 2024.

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.

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.

A key component of APRA's prudential framework is the suite of prudential standards that impose regulatory capital requirements on ADIs for the purpose of ensuring ADIs hold sufficient capital to address the risks associated with their operations. As Australia is a member of the Basel Committee on Banking Supervision (BCBS) and the Group of 20, Australia and APRA are committed to meeting internationally-agreed standards

for prudential regulation for ADIs by implementing capital standards that are based on the framework agreed by the BCBS.

APS 112 is one of APRA's core prudential standards that impose regulatory capital requirements on ADIs, by setting out the minimum credit risk capital requirements for ADIs on the Standardised Approach. APS 112, along with APRA's other core capital adequacy prudential standards, was designed to address Australian-specific risks and to ensure that ADI capital ratios will continue to be 'unquestionably strong' on an aggregate basis. APRA's capital standards have increased the financial strength of ADIs and supported the resilience of the Australian financial system. This helps to protect depositors, maintain market confidence and promote financial stability, especially during potential scenarios of financial stress.

APRA updated its ADI capital framework effective 1 January 2023. As part of industry implementation of the changes to APS 112, ADIs raised some technical queries relating to the operation and interpretation of the new standard. In response to these queries, APRA undertook a short consultation in 2024 on minor amendments to APS 112 to support industry implementation of the new capital requirements and to clarify APRA's requirements. This consultation was finalised on 26 June 2024.

These technical amendments included:

- *Risk weights for unrated corporate borrowers (paragraph 25 of Attachment A)* – Amendment to include risk weights that better reflect the underlying credit risk of unrated corporate exposures that are investment grade; and
- *Loan-to-value ratio (LVR) for non-arm's length property transactions (footnote 5 in Attachment A)* – Amendment to address the concern that the purchase price of a property might not accurately reflect the inherent LVR of the exposure in a non-arm's length transaction.

2. Purpose and operation of the instrument

The purpose of the instrument is to revoke the existing APS 112 and replace it with a new version of APS 112.

APS 112 requires the relevant ADIs to hold sufficient regulatory capital against their credit risk exposures. The existing APS 112 originally came into effect on 1 January 2023. In 2024, APRA made some minor amendments to APS 112 to clarify some technical issues raised by industry during implementation of the existing APS 112. This included updates to risk weights for unrated corporate borrowers, among other more minor amendments.

Details of the new prudential standard

See Attachment A.

Documents incorporated by reference

Under paragraph 14(1)(a) of the *Legislation Act 2003*, the standard incorporates by reference as in force from time to time:

- Acts of Parliament and associated delegated laws; and
- Prudential Standards determined by APRA under subsection 11AF(1) of the Act.

These documents may be freely obtained on the Federal Register of Legislation at www.legislation.gov.au.

Paragraph 13 of APS 112 requires an ADI to calculate the capital requirement in respect of an overseas banking subsidiary that is prudentially regulated by the Reserve Bank of New Zealand (RBNZ) using the RBNZ's equivalent prudential rules as in force from time to time. Subsection 11AF(7BA) of the Act provides that a prudential standard may provide for a matter by applying, adopting or incorporating any matter contained in an instrument or other writing as in force or existing from time to time, despite section 46AA of the *Acts Interpretation Act 1901* and section 14 of the *Legislation Act 2003*. Paragraph 13 of APS 112 relies on subsection 11AF(7BA) and incorporates by reference the following document as existing from time to time:

- *BPR130: Credit risk RWAs overview*, issued by the RBNZ and freely available at: <https://www.rbnz.govt.nz/regulation-and-supervision/oversight-of-banks/standards-and-requirements-for-banks/capital-and-credit-risk-requirements>.

Exercise of discretion by APRA

Under subsection 11AF(2) of the Act, a prudential standard may provide for APRA to exercise powers and discretions under the standard, including (but not limited to) discretions to approve, impose, adjust or exclude specific prudential requirements in relation to one or more specified ADIs or authorised NOHCs.

APRA's prudential standards include powers that may be exercised by APRA that involve an element of discretion and that may affect the interests of the entities to which the standards apply. These powers include a power to adjust or exclude a provision of the standard.

The need to apply discretion is driven by entity-specific issues and circumstances that are not adequately addressed by the generally applicable provisions of the prudential standards. For example, adjustment or exclusion of a provision may be necessary to obtain a better prudential outcome than would be the case if the prudential requirement were applied unaltered to a particular regulated entity.

When exercising its discretion, APRA considers a wide range of factors, including the considerations set out in the Act and the *Australian Prudential Regulation Authority Act 1998*.

The exercise of APRA's powers is governed by a robust decision-making framework which is documented in APRA's internal policies. This framework supports APRA in fulfilling its mandate by limiting decision making to those senior APRA officers with the appropriate experience and skill to exercise prudent judgement. The framework also requires decision makers to seek advice from internal technical experts.

The power is also exercised following discussion with the relevant entity about its appropriateness and the impact it may have on the entity.

Review of decisions

Decisions made by APRA exercising powers in prudential standards 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 also a breach of the Act, as section 11AG of the Act provides that ADIs and authorised NOHCs must comply with applicable prudential standards. However, there are no penalties prescribed for such breaches. 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). In nearly all cases the decision is preceded by a full consultation with the ADI to raise any concerns it may have in relation to the decision.

A decision of APRA to impose a direction is subject to merits review under section 11CA of the Act, which is appropriately available at the point where an ADI could be exposed to a penalty.

A decision of APRA to revoke an authority under the Act is subject to merits review, unless either:

- (a) APRA has determined that access to natural justice and merits review is contrary to the national interest or contrary to the interests of depositors with the ADI; or
- (b) the authority is an authority that is to cease to have effect on a day specified in the authority (subsection 9A(8) of the Act).

3. Consultation

On 5 December 2023, APRA released for consultation proposed minor amendments to APS 112 to address technical queries raised by industry in response to the existing APS 112 that came into effect on 1 January 2023. APRA finalised the proposed changes to APS 112 on 26 June 2024 following a three-month public consultation period.

APRA received six submissions in response to its consultation on the minor amendments, with non-confidential submissions available on APRA's website. Respondents were generally industry participants that welcomed the proposals, given the objective of the amendments was to better support industry implementation of the existing APS 112. Only minor amendments were made to APRA's original proposals to provide further clarity for industry.

Some respondents raised additional issues outside the scope of the consultation. These additional issues were either considered in previous consultations, and APRA's position remains unchanged, or related to requirements in different prudential standards that were not subject to this consultation.

4. Impact Analysis

The Office of Impact Analysis confirmed that a Regulation Impact Statement was not required.

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 B to this Explanatory Statement.

ATTACHMENT A

Details of the new prudential standard

Authority, application, commencement and interpretation

Under subsection 11AF(1) of the Act, APRA may determine prudential standards to be complied with by (among others) all, or specified classes of, ADIs and authorised NOHCs.

Paragraphs 1 to 8 are the machinery provisions relating to the legal authority under which the instrument is made, the classes of ADIs and authorised NOHCs that are required to comply with the standard, and the commencement date and interpretation of the standard.

Adjustments and exclusions

Paragraph 9 relies on subsection 11AF(2) of the Act and provides for APRA to adjust or exclude a specific prudential requirement in the standard in relation to one or more specified ADIs or authorised NOHCs.

Previous exercise of discretion

Paragraph 10 is a saving provision and provides that an exercise of APRA's discretion under a previous version of the standard continues to have effect.

Scope

Paragraphs 11 to 13 set out general requirements that relate to the calculation of credit risk exposures under the standard. Paragraph 11 excludes certain items from the scope of the standard. Paragraph 12 requires the ADI to apply the requirements in the standard to calculate the exposures of relevant overseas banking subsidiaries, except where they are prudentially regulated by the RBNZ. Paragraph 13 requires the ADI to apply the RBNZ's equivalent prudential rules where the subsidiary is prudentially regulated by the RBNZ.

Definitions

Paragraph 14 is a machinery provision setting out relevant definitions.

Key principles

Paragraphs 15 to 18 set out the key principles that ADIs must meet. This includes the general principle that an ADI must hold Regulatory Capital commensurate with its credit risk exposures, and that an ADI must establish and implement internal policies, processes, systems and controls to ensure that the ADI applies the appropriate risk weights as determined under APS 112 for its relevant credit risk exposures.

Risk-weighting approach

Paragraphs 19 to 21 set out the requirements for ADIs to calculate risk-weighted assets (RWA) to determine its relevant capital requirement under APS 112. It includes the

approach for different exposure types: on-balance sheet, off-balance sheet, and securities financing transactions.

Credit risk mitigation (CRM)

Paragraphs 22 to 25 set out the requirements for using techniques to mitigate an ADI's credit risk and reduce its capital requirement under APS 112. These techniques reduce an ADI's credit RWA for the purposes of calculating capital requirements.

Attachment A – Risk weights for property exposures

Attachment A to APS 112 sets out the risk weight requirements for property exposures, where property exposures are defined as exposures that are secured by immovable real property. However, risk weights for defaulted property exposures are set out in Attachment E to APS 112. Attachment A includes different sections for each property exposure subcategory.

- *Standard property loans* (paragraphs 2 to 8) – sets out the requirements for categorising an exposure as a standard property loan. This is used for determining risk weights for standard property exposures in Attachment A.
- *Loan-to-valuation ratio (LVR)* (paragraphs 9 to 12) – sets out the requirements for calculating an exposure's LVR. The LVR is used to determine risk weights for property exposures in Attachment A. It includes requirements around valuing property used in the LVR calculation.
- *Credit risk mitigation* (paragraph 13) – clarifies that an ADI can use CRM techniques to reduce an exposure, but the LVR and risk weight of an exposure must be determined before the application of the CRM technique.
- *Residential property* (paragraphs 14 to 21) – sets out requirements for risk-weighting property exposures that are predominantly secured by residential property. Residential property includes owner-occupied loans, principal-and-interest loans and 'other standard residential property' loans. 'Other standard residential property' loans are residential property exposures that do not meet the criteria in paragraphs 14(a) and 14(b) of Attachment A to APS 112. This section sets out the prescribed risk weights for these loan types.
- *Commercial property* (paragraphs 22 to 26) – sets out the requirements for risk-weighting property exposures that are not residential property exposures defined in paragraph 14 of Attachment A to APS 112. This section categorises commercial property as either dependent on property cash flows or not dependent on property cash flows. The exposure is then risk weighted depending on whether it is classified as a standard loan and its LVR.
- *Land acquisition, development and construction* (paragraphs 27 to 30) – sets out the requirements for risk weighting property exposures that are secured predominantly by land acquisition for development and construction purposes, or development and construction of any residential or commercial property.

Paragraph 29 provides for a concessional risk weight where the exposure meets certain technical criteria.

Attachment B – Risk weights for non-property exposures

Attachment B to APS 112 sets out the risk weights for exposures that are not secured by property. This excludes unsettled and failed transactions, which are risk weighted in accordance with Attachment D to APS 112, and defaulted exposures, which are risk weighted in accordance with Attachment E to APS 112. This Attachment includes different sections for the relevant exposure categories.

- *Sovereign exposures* (paragraphs 3 to 5) – defines sovereign exposures and sets out the applicable risk weights for these exposures.
- *Domestic public sector entities* (paragraph 6) – sets out the risk weights for exposures to domestic public sector entities that are not sovereign exposures.
- *Bank exposures* (paragraphs 7 to 17) – sets out the risk weights for exposures to bank counterparties, excluding equity or subordinated debt. This includes exposures to domestic and international banks, and multilateral development banks that are not eligible for risk weights in accordance with paragraph 3(c) of Attachment B to APS 112. This section also includes risk weights for covered bonds.
- *Corporate exposures* (paragraphs 18 to 29) – sets out the risk weights for exposures to corporate counterparties. This section includes different categories of corporate counterparties, including general corporate with a credit rating, small- and medium-sized enterprise without a credit rating, other general corporate, and specialised lending.
- *Retail exposures* (paragraphs 30 and 31) – sets out the risk weights for exposures to one or more individuals that are not property or margin lending exposures. These exposures are categorised as either credit card exposures or other retail exposures.
- *Margin lending exposures* (paragraph 32) – sets out the risk weights for margin lending exposures secured by eligible financial collateral and other collateral.
- *Subordinated debt* (paragraph 33) – sets out the risk weights for subordinated debt, which includes any facility that is expressly subordinated to another facility.
- *Equity* (paragraphs 34 to 38) – sets out the risk weights for equity exposures. This section sets out the technical criteria for classifying an exposure as an equity exposure and the risk weights for these exposures where they are not required to be deducted from Regulatory Capital under *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*.
- *Leases* (paragraphs 39 and 40) – sets out the risk weights for lease exposures, which includes all lease and asset finance exposures, irrespective of the counterparty type.
- *Exposures through a third party* (paragraph 41) – sets out the risk weight for credit exposures originated through a third party.

- *Other exposures* (paragraph 42) – sets out the risk weights for all other exposures that are not property exposures or specified in Attachment B to APS 112.
- *Risk weight multiplier for certain exposures with currency mismatch* (paragraphs 43 and 44) – sets out the requirements for risk weight multipliers for unhedged retail or residential property exposures to individuals that were originated after 1 January 2023 where the lending currency differs from the currency of the borrower’s source of income.

Attachment C – Off-balance sheet commitments

Attachment C to APS 112 sets out the capital requirements for off-balance sheet exposures. For exposures that meet the definition of an off-balance sheet exposure, an ADI must apply the appropriate credit conversion factors set out in this Attachment before applying the applicable risk weight as determined by APS 112.

Attachment D – Unsettled and failed transactions

Attachment D to APS 112 sets out the capital requirements for unsettled and failed transactions. This attachment sets out the definition of delivery-versus-payment transactions and the applicable risk weights for these exposure types.

Attachment E – Defaulted exposures

Attachment E to APS 112 sets out the risk weights for an exposure that is in default. Defaulted exposures are categorised as either residential property exposures or other defaulted exposures.

Attachment F – External credit ratings

Attachment F to APS 112 sets out the requirements for using credit ratings provided by external credit assessment institutions. These credit ratings are used to determine risk weights for exposures as prescribed by APS 112.

Attachment G – Collateralised transactions

Attachment G to APS 112 specifies how an ADI may apply CRM techniques to transactions secured by received collateral.

Attachment H – Netting

Attachment H to APS 112 sets out the requirements for an ADI to use close-out netting and netting by novation to reduce its exposure amount for the purpose of calculating Regulatory Capital requirements.

Attachment I – Guarantees

Attachment I to APS 112 sets out the requirements for an ADI to use guarantees to substitute the risk weight of a counterparty for the risk weight of the guarantor for the covered portion of the exposure to reduce the amount of Regulatory Capital that must

be held for an exposure. This Attachment sets out the minimum requirements for an eligible guarantee and an eligible guarantor.

Attachment J – Credit derivatives

Attachment J to APS 112 sets out the requirements for an ADI to use credit derivatives to reduce its capital requirements. This attachment limits eligible credit derivatives to single-name credit-default swaps and certain total-rate-of-return swaps, and sets out the minimum requirements for these derivatives to be eligible under APS 112.

ATTACHMENT B

Statement of Compatibility with Human Rights

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

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This legislative 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 the legislative instrument is to revoke *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) and replace it with a new APS 112.

APS 112 requires authorised deposit-taking institutions (ADIs) to hold sufficient regulatory capital against credit risk exposures. ADIs are bodies corporate that have been granted the authority, under the *Banking Act 1959*, to carry on banking business in Australia.

Human rights implications

APRA has assessed the legislative 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 legislative instrument is compatible with human rights.

Conclusion

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