

Banking (prudential standard) determination No. 2 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. 2 of 2024 (the instrument), which revokes *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* made under Banking (prudential standard) determination No. 7 of 2022 and determines a new *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113).

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 113 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 Internal Ratings-based Approach. APS 113, 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 113, 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 113 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 include:

- *Loss Given Default (LGD) for domestic public infrastructure (paragraph 10 of Attachment B)* – Removal of the condition that an ADI should remove the prospect of government support from Probability of Default assessments to qualify for the lower LGD. Additionally, clarification of expectations in relation to security agreements and step-in rights;
- *LGD for carbon credits and allowances (paragraph 11 and table 4 of Attachment B)* – Amendment to recognise the recoverable value of carbon credits and allowances;
- *Public sector entities that carry out the functions of a financial institution (paragraphs 30 and 34)* – Clarification that public sector entities that carry out the functions of a financial institution should be captured under the financial institution asset class as they share similar risk characteristics as financial institutions; and
- *Internal-ratings based scalar for exposures subject to the Reserve Bank of New Zealand's (RBNZ) supervisory slotting approach (paragraph 13(a))* – Clarification that the 1.1 scaling factor should be applied to New Zealand exposures subject to the RBNZ's supervisory slotting approach as the intent of the standard is that RBNZ capital requirements flow through to Level 2 regulatory capital.

2. Purpose and operation of the instrument

The purpose of the instrument is to revoke the existing APS 113 and replace it with a new version of APS 113.

APS 113 requires the relevant ADIs to hold sufficient regulatory capital against their credit risk exposures. The existing APS 113 originally came into effect on 1 January 2023. In 2024, APRA made some minor amendments to APS 113 to clarify some technical issues raised by industry during implementation of the existing APS 113. This

included updates to loss given default requirements for domestic public infrastructure exposures, 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 113 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 113 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 (section 9A(8) of the Act).

3. Consultation

On 5 December 2023, APRA released for consultation proposed minor amendments to APS 113 to address technical queries raised by industry in response to the existing APS 113 that came into effect on 1 January 2023. APRA finalised the proposed changes to APS 113 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 113. 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 ADIs and authorised NOHCs that are required to comply with the standard, the commencement date, and interpretation.

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 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 (with modifications) 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 19 set out the key principles that ADIs must meet. This includes the general requirement that an ADI can only rely on its internal credit risk estimates for determining its Regulatory Capital requirements if it has received APRA approval (IRB approval). This section also sets out some general constraints for using internal estimates depending on whether the ADI has received foundation or advanced IRB approval. Paragraph 19 references credit risk mitigation (CRM) techniques in *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) that an ADI may use to reduce its Regulatory Capital requirement.

Governance and oversight

Paragraphs 20 to 23 set out governance and oversight requirements. This includes that all material aspects of an ADI's rating and estimation process must be approved by the ADI's Board and senior management. Additionally, senior management must understand the design and operation of an ADI's rating systems and approve any material differences identified between established procedures and actual practice. Paragraph 22 requires internal ratings to be reported to the Board and senior management and paragraph 23 requires an ADI to have documented policies that detail sound rating system development, validation, implementation, governance and control processes.

Credit risk control

Paragraphs 24 to 26 requires an ADI to have an independent credit risk control unit. The independent credit risk control unit must actively participate in the development, selection, implementation and validation of rating models, and an ADI's policies must clearly define and document relevant accountabilities.

Independent review

Paragraph 27 requires an ADI's rating systems and operations to be reviewed at least annually by an independent function.

Asset classes

Paragraphs 28 to 41 require an ADI to assign its exposures to particular asset classes for determining its Regulatory Capital requirements and define each asset class. These asset classes include:

- *Corporate exposures* (paragraphs 30 to 32) which includes all credit exposures to corporate counterparties and public sector entities;
- *Sovereign exposures* (paragraph 33) which is defined under APS 112;
- *Financial institution exposures* (paragraph 34) which includes all credit exposures to financial institution counterparties and public sector entities that carry out the functions of a financial institution; and
- *Retail exposures* (paragraphs 35 to 41) which includes retail residential mortgage exposures, qualifying revolving retail exposures, small- and medium-sized enterprise retail exposures, and other retail exposures.

IRB approval

Paragraphs 42 to 56 set out the requirements for an ADI to receive APRA approval to use an IRB approach for Regulatory Capital purposes. This includes two sections:

- *Initial approval* (paragraphs 44 to 51) which sets out initial requirements an ADI must meet for its IRB application. This section also includes requirements for a phased roll-out, where it is not practical for an ADI to implement an IRB approach

across all material asset classes and business units at the same time. In exceptional circumstances, APRA may approve permanent partial use of an IRB approach.

- *Ongoing requirements* (paragraphs 52 to 56) which sets out the ongoing requirements for an ADI that has received IRB approval. Following APRA's initial approval, and ADI must seek further APRA approval to make changes to its rating systems that result in a material change in risk-weighted assets (RWA) or a significant change to its modelling assumptions. This section also sets out the circumstances where APRA may vary or revoke an IRB approval, or impose additional conditions on the IRB approval.

Attachment A – IRB risk-weight functions

Attachment A to APS 113 sets out the risk weight functions for calculating RWA for corporate, sovereign, financial institution and retail exposures. Attachment A also sets out the requirements for calculating RWA for specialised lending exposures subject to the supervisory slotting approach, lease exposures, and defaulted exposures.

Attachment B – Risk components for each asset class

Attachment B to APS 113 sets out the requirements for an ADI to calculate the risk components for each asset class in APS 113. These risk components include probability of default, loss given default, exposure at default, and effective maturity.

Attachment C – Treatment of expected losses and provisions

Attachment C to APS 113 sets out the requirements for an ADI to separately calculate the total expected losses amount aggregated across each IRB asset class, the requirements for the calculation of eligible provisions, and the treatment of expected loss and provisions.

Attachment D – Minimum requirements for the use of an IRB approach

Attachment D to APS 113 sets out the minimum requirements that an ADI must meet at the time of IRB approval by APRA and on an ongoing basis. These requirements relate to rating system design, rating system operations, use of internal ratings, risk quantification, and validation of internal estimates.

Attachment E – Requirements for recognition of collateral and credit risk mitigation

Attachment E to APS 113 sets out the requirements for eligible collateral and using CRM techniques for reducing credit risk exposures. These requirements differ depending on whether an ADI has received foundation IRB approval or advanced IRB approval.

Attachment F – Risk-weighted assets for purchased receivables

Attachment F to APS 113 sets out the requirements for how an ADI must treat purchased receivables. There are two categories of purchased receivables set out in this attachment: retail receivable and corporate receivables.

Attachment G – Supervisory slotting criteria

Attachment G to APS 113 sets out the supervisory slotting criteria for project finance exposures, income-producing real estate exposures, object finance disclosures, and commodities finance exposures.

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 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113) and replace it with a new APS 113.

APS 113 requires certain 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.