Australian Prudential Regulation Authority

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To all locally incorporated Authorised Deposit-taking Institutions (ADIs)

TREATMENT OF LOANS TO SELF-MANAGED SUPERANNUATION FUNDS

The purpose of this letter is to clarify the appropriate capital treatment of ADIs' loans to self-managed superannuation funds (SMSFs) that are secured by residential mortgages (SMSF loans) under *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) and *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113).

APS 112 requires an ADI to classify a loan secured against a residential mortgage as either a 'standard' or 'non-standard' eligible mortgage and to apply an appropriate risk-weight depending on the loan-to-valuation ratio and on whether there is lenders mortgage insurance provided by an acceptable lenders mortgage insurer (refer to Attachment D to the current APS 112). APS 113 requires an ADI that has APRA's approval to use the internal ratings-based (IRB) approach to credit risk to assign each retail exposure into a particular risk pool based on, among other things, obligor and transaction risk characteristics (refer to Attachment A to APS 113).

APRA wishes to clarify that, for the purposes of APS 112, SMSF loans are to be treated as 'non-standard' eligible mortgages. This is because the structures involved in SMSF loans:

- are relatively more complex than those for 'standard' eligible mortgages. For example, the borrower (an SMSF) would not 'own' the asset; instead, it would be a beneficiary under a trust structure;
- involve no recourse rights to an SMSF's other assets, beyond the asset being funded; and
- require more complex arrangements such as personal guarantees, with insufficient empirical evidence as yet on the relative strength of the pledging arrangement or the ultimate enforceability of the personal guarantees in comparison to more traditional arrangements.

As such, SMSF loans may have a different and potentially higher loss profile in comparison to standard loans.

For the purposes of APS 113, APRA expects that the risk estimates assigned to SMSF loans under the IRB approach to credit risk would be modelled separately, reflecting the different loss characteristics of those loans. APRA's expectation, however, is that there is likely to be insufficient data available to support such modelling. If sufficient data is not available, required capital for SMSF loans should be determined under the standardised approach (APS 112) in line with the above guidance.

APRA also wishes to emphasise that, where an ADI is extending credit to SMSFs, it is the ADI's responsibility to ensure that it has given detailed consideration to the particular risks of lending to a superannuation fund, and that its application process verifies all relevant compliance matters that might impact on the ability of an SMSF to service the loan.

Please contact the Responsible Supervisor for your institution if you need any further clarification.

Yours sincerely

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