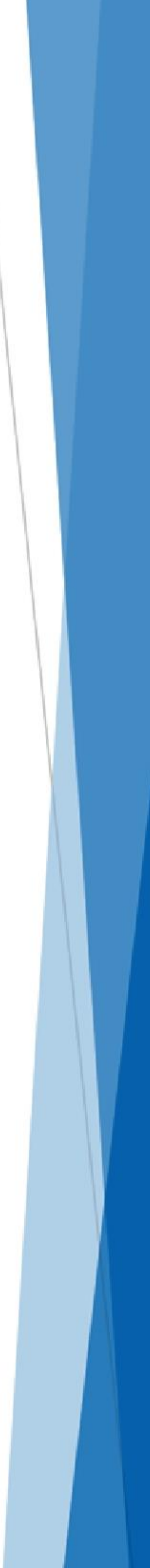

ADI capital reforms: Minor updates

8 March 2024

Australian Banking Association

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About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

Australian Banking Association

ABA submission to APRA

The ABA would like to thank APRA for the opportunity to provide feedback as part of the consultation process on the proposed minor updates to the capital framework. We are appreciative of the consideration APRA has shown in soliciting industry feedback following implementation of Basel 3 and note many of the items raised by the ABA and through bilateral means are captured in the proposed changes.

Our submission will consider the proposals as outlined in Annex A in the letter to ADIs 'ADI capital reforms: Minor updates' issued on 5 December 2023. Industry would also like to raise some related issues on the treatment of infrastructure, comparable direct exposure and the transitional arrangements for market risk when determining the capital floor – details of these are included on page 10.

However, we seek some initial clarification on the implementation timeline that apply across all of the outlined changes.

Implementation timeframes

APRA has proposed the minor updates to the capital framework become effective from 30 June 2024. Industry interprets this such that regulatory reporting and external disclosures for the period ending 30 June 2024 would be impacted.

While the ABA acknowledges that most of the proposed changes will be minor, some will require new data, updates to existing policies and procedures, and/or amendments to business and risk management processes. Some of the proposed revisions will require significant testing to ensure the changes are accurately reflected in all reporting submissions and external disclosures. With the consultation process ending in March 2024 and final standards likely to be published shortly after, an implementation period of less than 3 months is unlikely to be adequate for ADIs to robustly complete implementation and associated testing and assurance activities.

The ABA recommend:

- Amending the implementation date for the minor updates to APS 112, 113, APG 110, 112, 113, and ARS 110.0, 112.0, 113.0 and 115.0 to 1 July 2024, to allow ADIs additional time to update all impacted processes in time for the September 2024 reporting period.

Turning to the specific proposals:

1. Risk Weight for unrated corporate (non-SME) borrowers

The ABA is appreciative of APRA providing an alternative framework in response to challenges in obtaining external credit ratings for corporates. However, the ABA notes that the draft approach in its current form does not provide an alternative which Industry would implement. Specifically:

- Analysis by Industry has determined a low proportion of both investment and non-investment grade customers in this unrated corporate cohort are publicly listed on a self-or-parent basis.
- As both conditions need to be met (i.e. investment grade and publicly listed), potentially only a small proportion of ADIs' unrated Corporate-other portfolios will qualify for the 85 per cent risk weight, with the remainder now subject to 110 per cent risk weight. Therefore, many large, high-quality private corporate groups and investment funds will now be subject to an increase in risk weight (i.e. versus 100 per cent).

The expected outcome is that adoption of bifurcated approach to risk weights as currently drafted is not likely across the industry. As such, members will likely continue with the fixed 100 per cent risk weight for all unrated corporates, which is reflective of the operational challenges of identifying the listed status.

A review of international peers (such as the UK, EU, Canada) suggests the proposed draft would be an outlier in requiring *both* "Listed and Investment grade" as well as having a higher risk weight for exposures which do not meet this definition.

The APS 112 corporate asset class includes a wide variety of entities, including privately held corporates, investment and superannuation funds, real estate companies, insurance companies and other financial institutions. These entities have a wide variety of business models, many of which do not include publicly listed securities.

The ABA understands that publicly traded corporate entities are subject to enhanced transparency and market discipline as a result of being listed publicly on an exchange. However, for this cohort of larger, investment grade-equivalent credits, banks require financial statements before lending to privately held companies. Similarly, investment fund managers are subject to their own transparency obligations based on their own jurisdictions.

This investment grade segment typically represents a one-year PD up to approximately 0.4 per cent (BBB- equivalent). This compares with typical PD ranges across SME portfolios of 1 per cent to 4 per cent, noting that SME risk weights are set at 75 per cent and 85 per cent, irrespective of tenor, external ratings or listed status.

As APRA is aware, for IRB banks these internal PD assessments are derived from extensive modelling, supported by PD migration history and default data. These PD models in themselves require extensive and ongoing financial and non-financial information, including financial statements and other management reporting.

In view of the above, whilst acknowledging the governance and transparency benefits, ABA believe that it is not clear that a corporate entity having a listed security would better reflect the probability of default than the underwriting and ongoing credit management processes of member ADIs.[1]

In the ABA's view, the approach taken in the UK is a practical approach that could be adopted here.

In respect of the risk weights to apply:

- A concessional risk weight of 65 per cent has been referenced across a number of jurisdictions, which in each case have used Basel as a reference point. Accordingly, use of a 65 per cent risk weight for unrated investment grade would place Australia in line with Basel and other similar jurisdictions.
- The ABA agrees with the logic applied in the UK that if a more beneficial risk weight for qualifying credits can be applied (i.e. are investment grade), there should be an equivalent "penalty" for the remainder. This retains the overall 100 per cent average risk weight calibration (an arithmetic average of the two risk weights).

[1] We refer to the following US-based reference for more detailed discussion of this topic: Bank Policy Institute and American Bankers Association Memorandum to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, dated 16 January 2024 (page 61).

- On this basis, the risk weight for unrated exposures that do not meet the internally assessed investment grade criteria would be 135 per cent. For rated customers, this risk weight lies beyond the mid-way point between CRG 4 and CRG (5 & 6), being the two sub-investment grade risk weight factors.
- ABA members would welcome further discussions on the estimated impact on the calibration of the capital framework of this potential option and those which are in place in other jurisdictions.

The ABA believes that these factors provide a reasonable degree of risk sensitivity which appropriately differentiates between investment grade and non-investment grade credits.

We note banks could choose to retain a flat 100 per cent risk weight. This would avoid an unnecessarily punitive treatment for standardised banks whose corporate portfolios are concentrated around smaller sub-investment grade customers.

2. LGD for domestic public infrastructure

The ABA thank APRA for responding to the treatment of domestic public infrastructure exposures following questions raised by the ABA. While welcoming the changes, the ABA have some comments on the proposals (following) and would like to raise some related issues on the treatment of infrastructure (see page 10):

1) Remove probability of default double counting reference

ABA recommend removing the line "*To avoid double counting, the likelihood of government capital contribution must not be factored into the probability of default*" from APS 113, Attachment B, Paragraph 10 a).

When assessing PD in instances where a counterparty is wholly or majority government owned, PD must reflect consideration of government intervention to avoid default. Where government intervention is likely, this also mitigates losses in the unlikely event of default and is thus a consideration in assessment of LGD.

While not considered Sovereign asset class where PD and LGD are mitigated, being wholly or majority government owned reduces default risk (if assessed to have high degree of government oversight) and loss (due to a high likelihood of government contribution) if default were to eventuate. Entities supporting large domestic public infrastructure assets are critical in nature, ensuring government provides support to both avoid default and mitigate the losses in the unlikely event of a default.

Examples include (but are not limited to) airports, ports and energy which benefit from both government ownership and are operators of critical Australian infrastructure. If these were subsequently privatised the counterparty would most likely benefit from a tripartite per paragraph 10 b) and government support can be factored in the PD. This treatment of a privatised entity would be inconsistent with the treatment of a government-owned entity under 10 a).

Risk weight could be as much as tripled where consideration of the government ownership and/or support is not considered as part of the PD assessment. Further, all of the relevant PD information is required to be assessed in line with rating criteria (APS 113, Attachment D, Paragraphs 19 - 23).

As is the case with determination of Sovereign risk weights, the ABA recommend the likelihood of government support should be considered in both PD and LGD determinations.

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2) Treatment of government-owned investors in public infrastructure

APRA's initial draft positioning in July 2023 on the treatment of LGD for domestic public infrastructure included Queensland Investment Corporation (QIC), where ownership is wholly or predominantly government, but they are not operators of public infrastructure. QIC's mandate includes investment in infrastructure and while not necessarily operators, loss positioning is aligned to other similar government owned entities. Therefore, the ABA believes that the proposed 25 per cent LGD for publicly owned/controlled domestic infrastructure operators should extend to publicly owned and/or controlled infrastructure investors.

3) Addition of Statutory Bodies

Provisions in APS 113 Paragraph 10 b) should be expanded to mirror arrangements under Paragraph 10 a) by capturing government-owned entities and 'statutory bodies' whereby a contractual agreement with step-in rights may be with government or a corporation owned or controlled by a government. 'Statutory bodies' capture entities that are technically neither owned nor controlled by the government but owned by a statutory trust supporting key government critical infrastructure initiatives where the entity is owned by a statutory body (e.g. NSW SFV as part of the NSW Government Electricity Infrastructure Investment Roadmap).

Relatedly, we also propose additional changes to clarify that a GSA (or other relevant security agreements) over the operating assets of the borrower will be with the ADI. The current draft wording could be read as requiring a GSA between the borrower and the Government.

<u>Proposed text for paragraph 10 b)</u>

"the borrower has in place a **relevant** security agreement **with the ADI** and a contractual agreements with the Australian Government or an Australian State or Territory government **or a corporation wholly or majority owned or controlled by the Australian Government or an Australian State or Territory government or a statutory body** that provide the ADI…".

4) Include right to cure a default under the underlying project agreement

Paragraph 10b) should be expanded to include the right to 'cure default'. This critical amendment is required where an ADI will typically cure default under a project agreement first without resorting to enforcement action to taking control of an operation.

Right to take control is a right derived from facility and security agreements and not contained in contractual agreements with government i.e. tripartite does not include enforcement provisions in favour of banks and only step-in rights to 'cure default' under underlying project agreements.

Interpretation of this provision applies where:

- A borrower has in place a general security agreement; AND
- A contractual agreement is in place with government/government-related entities providing an ADI with the right to cure default under project agreements or take control of the project/infrastructure in event of default.

This provision places emphasis on both existence of security and step-in rights under a tripartite between the ADI, the project and the government/GRE. ABA interprets the intent is to ensure where government has a project agreement with a borrower and a tripartite agreement exists, loss given default is mitigated by security and step-in rights in favour of the ADI under the tripartite, as the ADI has additional rights to cure default and may take enforcement action to minimise loss. Government leverage of the tripartite and the general security agreement in favour of the ADI

(rather than government ownership per paragraph a)) minimises likelihood of loss on borrower default.

Industry consider this provision is intended to support Australian critical infrastructure projects where government does not own the borrower but provides support by virtue of a tripartite e.g. Capacity Investment Scheme (Commonwealth), VRET (Victoria) and Long Term Energy Services Agreement (LTESA - NSW) provide a borrower with a level of contracting under an underlying project agreement. Where the borrower is a platform energy company, the project agreement forms part of the contracting arrangement but will not be the sole contracting arrangement. Government motivation is to ensure the borrower seeks other third-party contracts, with government arrangement acting as the catalyst for further investment. The ABA believe the energy sector is a critical infrastructure segment (i.e. decarbonisation of the Australian National Electricity Market is fundamental to Australia's transitioning to a net zero carbon economy) and as such where tripartites exist under relevant government schemes and the borrower has provided security, requirements of Paragraph 10 b) are met.

A redacted example:

- Funding to an energy platform company with many power purchase agreements with third parties;
- ~20 per cent with government/GRE

This satisfies proposed requirements as the arrangement has a GSA in favour of the banks and a tripartite agreement with the state government/GRE, where banks have step-in rights to cure default. The intention of such government schemes is to 'crowd in' third party contracts i.e. government does not wish to be the sole off-taker in the energy market. Existence of the GSA and the tripartite arrangement in favour of the ADI gives government comfort default under the project contract will be addressed notwithstanding its contract may only represent a smaller portion of energy platform company assets.

Proposed text for paragraph 10 b) (noting proposed changes from point b) above)

"the borrower has in place a relevant security agreement with an ADI and a contractual agreements with the Australian Government or an Australian State or Territory government or a corporation wholly or majority owned or controlled by the Australian Government or an Australian State or Territory government or a statutory body that provide the ADI with the **right to cure a default under the underlying project agreement** or take control of the operation of the infrastructure (step-in rights) in the event of default. In addition, where the borrower's revenue is based on fees from service users, demand for the service is assessed to be strong by the ADI".

3. LGD for carbon credits and allowances

The ABA welcomes APRA's recognition of the recoverable value of carbon credits in its prudential capital framework. With the Federal Government legislating climate targets, this will assist Australian ADIs to play an active role in attracting investment, as well as playing an intermediary role in allocating capital towards less carbon intensive activity and promoting low carbon alternatives and decarbonisation technologies.

Industry would like to highlight that typically a lot of the business transacted with respect to environmental products is in the form of repurchase agreements. These may be documented under market standard repurchase agreements (e.g. Global Master Repurchase Agreements) or,

alternatively, may involve the spot purchase of inventory plus fixed price forward sale to the same counterparty. In these cases, the ADI holds title to the inventory until maturity which means that, unlike pledged collateral, it can be liquidated in the event of the seller's insolvency without interference from an insolvency court.

Therefore, the requirement in draft APS 113, Attachment B, paragraph 11 that "the ADI must have a perfected security interest in the collateral" prevents the application of the eligible recovery value Supervisory LGD estimates to repo financing structures, which are a common financing structure in physical commodity and carbon markets. Given repos offer credit risk mitigation which is at least equivalent to pledged collateral arrangements, we recommend that APS 113 be updated to accommodate such financing arrangements in the context of the Supervisory LGD estimates for exposures with eligible recovery value.

4. Credit worthiness checks prior to drawdowns

The ABA welcomes the additional option to use policy and process to facilitate the pre-drawdown credit check for commitment exemptions. We propose some amendments to the text to allow these requirements to be met through banks' existing monitoring measures for commitments, as well as promoting greater consistency in the guidelines.

Firstly, in paragraphs 62 a) ii) and 62 b) ii) of APG 112, we propose amending "the following risk indicators" to "risk indicators such as". This change reflects that there may be a number of creditworthiness tests an ADI can undertake using existing credit policies and data to meet the general requirement of the guidance rather than restricting the measures to a specific list. This would prevent an unnecessarily burden on the ADI's operational processes and allow ADIs to implement the requirements to fit within their environment.

Relatedly, to provide flexibility and enable an ADI to leverage existing policy and processes, it is recommended that within APG 112 paragraph 62 a) ii), the reference to "auditable checklists" should be amended to read "auditable process". An auditable process would allow for the combined use of existing credit policies and processes that ensure certain risk indicators are monitored on an ongoing basis and, where these existing policy and processes do not address the requirements for certain risk indicators to be monitored on an ongoing basis, an auditable checklist would be completed.

In APG 112 paragraph 62 there is reference that "*that a creditworthiness assessment must be undertaken by an independent <u>third</u> party <u>immediately prior to drawdown</u>".* The ABA propose that the word "third" should be removed as third parties generally refer to entities outside of the ADI. Further, we request that the wording "immediately prior to drawdown" be changed to "prior to approving a drawdown" to bring it into alignment with the wording in paragraph 62 a) i).

Consistent with industry feedback submitted in August 2023, the ABA requests that APRA considers extending the window in a which a credit worthiness assessment may be undertaken under paragraph 62 a) i) of APG 112. Extending the window for which a creditworthiness assessment remains valid to five business days, rather than 24 hours, would significantly reduce operational complexity for portfolios with frequent drawdown requests, whilst still ensuring timely monitoring and consideration of any material deterioration in the credit worthiness of borrowers.

Extension of the window in which a creditworthiness assessment may be undertaken would also support scenarios such as uncommitted facilities being drawn across multiple time zones.

5. IRB Scalar for exposures subject to RBNZ's supervisory slotting

The ABA appreciates APRA's clarification of the application of the 1.1 scaling factor applicable to RBNZ regulated exposures using the supervisory slotted approach. APRA's expectation of the treatment of these exposures is now clear in the prudential standards.

6. LGD for multilateral organisations

The ABA is supportive of APRA's changes to recognise the Bank for International Settlements (BIS), the International Monetary Fund (IMF) and the Multilateral Investment Guarantee Agency for use of the 5 per cent Sovereign LGD under APS 113. We appreciate APRA's quick response and action on the ABA's queries on this topic.

7. Public Sector Entities that carry out the functions of a financial institution

The ABA welcome the proposed clarification.

8. Loan to Value Ratio (LVR) for non-arm's length property transactions

Industry welcomes APRA's proposed changes to paragraph 11 of Attachment A to APS 112 and footnote 5, allowing for valuations greater than effective purchase price to be utilised in the calculation of regulatory LVR for non-arm's length property transactions.[2]

The ABA notes that there is a range of instances where the effective purchase price will not reflect its market value when financing the purchase of a property, i.e. not just limited to non-arm's length transactions. Such instances include, but are not limited to, the exercise of historic options to buy or sell a property at a given price, and sales with extended settlement periods (where the price was negotiated in weaker market conditions or planning and zoning changes have increased the market value of the property after execution of the contract of sale).

The ABA propose that where an ADI has established policies and procedures for the acceptance of independent external valuations, aligned to the requirements of APS 220, these valuations should be eligible for use in the calculation of regulatory LVR at origination under APS 112. These changes would ensure that valuations used in the regulatory LVR calculation are reflective of the current market value of property collateral, and better align the valuations used in APS 112 RWA determination with those used in LGD estimation under APS 113. On this basis, the ABA kindly requests that APRA considers modifying footnote 5 from paragraph 11 of Attachment A to APS 112.

[2] For the purposes of this section, the ABA note that this valuation applies only at origination or the specific scenarios where the valuation can be updated per APS 112 Attachment A Paragraph 11.

9. Treatment of trusts in five or more investment properties

ABA members have expressed some concern with the five or more property requirement and the variations that can occur in implementation due to dependencies on differing origination and data collection practices.

Firstly, there would need to be clarity around definitions and approach to identifying multi-property borrowers. Further, the changes necessary for some ADIs to collect and verify the required data will require additional resources.

In addition, analysis undertaken by some ADIs has indicated that the risk of property concentration is captured in existing PD or LGD models and hence the additional scalar may not be warranted.

The ABA and industry would welcome a workshop with APRA to discuss these concerns in more detail.

10. Public disclosure of overlays

The ABA note the proposed change.

11. Validation of supervisory LGD and EAD estimates

The ABA appreciate the updated guidance that APRA has provided on the validation of supervisory LGD and EAD estimates. Industry notes that for some customers and facilities, the updated supervisory estimates will only apply once the minor amendments to the capital framework are effective (e.g. changes to LGD estimates for infrastructure operators).

The ABA recommends that:

- Validation of the supervisory estimates only apply from the date the estimates become effective.

12. Controls on business function approval of ratings

The ABA welcome the inclusion of additional guidance.

13. Changes to reporting standards

The ABA welcome the proposed changes, which better align the reporting and capital standards.

Further issues

1) Other infrastructure matters

a) Non-domestic infrastructure

To date, APRA have limited application of Infrastructure LGD to domestic operators. While understanding primary objectives of support for Australian infrastructure, this impacts Australian ADI international competitiveness and ability to support Australian customers operating in foreign markets. Further, high quality infrastructure projects being operated internationally provide for low-risk business that enable Australian banks to diversify their balance sheets which in turn provides a domestic benefit.

Industry and the ABA would welcome further engagement with APRA on the capital treatment of both domestic and non-domestic infrastructure upon implementation of BCBS regulation in other key jurisdictions. Where EU or US regulation has a broad application of infrastructure support (as is the case now), ABA recommends APRA consider application of concessional LGD in line with international regulation.

b) Extension of the concessional 25 per cent LGD for Renewable Energy Infrastructure

As part of revisions to APS 113, APRA proposed a 25 per cent LGD concession for senior exposures to operators of domestic large public infrastructure assets or utilities. ABA considers the 25 per cent LGD concession should be extended to also cover senior exposure to infrastructure required to address global risks to climate change and which contribute towards the delivery of global climate change targets such as the 2050 Net Zero Climate change commitments. There are several factors to consider:

- Climate change is a global issue that will require significant investment in Renewable energy generation assets to deliver the Global Net Zero targets by 2050.
- To meet these aggressive targets, Australian banks will need to play a key role globally to support the required investment needed in renewable energy generation to deliver on these obligations.
- Banks have been important providers of structured debt capital to finance renewable energy projects. Going forward and given banks have signed up to various external commitments (e.g. NZBA (Net Zero Banking Alliance)), we expect this to continue.
- Significant capital flows, out of hydrocarbon intensive industries into renewables is occurring, supporting market pricing and demand for renewable assets and therefore expected recovery rates in the event of default.
- Low historical loss rate on renewable assets. The renewables segment is resilient and low losses have been realised.
- Bloomberg New Energy Finance have recently estimated that reaching net zero by mid-century globally requires approximately US$195 trillion of investment, 18 per cent of which is attributed to low carbon power. Given renewables are capital intensive, efficient funding (including bank debt) is important to lower the delivered cost of new renewable generation.
- Understanding that under the CRR3 Standardised Approach, the EBA is providing concessional Risk weighting treatment to exposures that contribute to EU sustainability

objectives via the Infrastructure Support Factor (ISF), and has introduced Article 495b that mandates the EBA assess the adequacy of the LGD floors applicable to specialised lending exposures under the IRB approach.

In line with recommendation on non-domestic infrastructure above, industry and the ABA would welcome further engagement with APRA on the capital treatment of renewable energy infrastructure and assets, including those exposures currently classified as Specialised Lending.

c) FIRB threshold and AIRB collateral alignment

As highlighted, the potential market for infrastructure and natural resources, including renewables, is significant and impacted by application of the FIRB large corporate threshold. Greenfield projects will quickly exceed the current $750 million large corporate threshold whereby FIRB and AIRB differences in recognised collateral are exacerbated – particularly 'other' collateral types or those outside of other physical collateral constraints.

The ABA recommend APRA consider alternative options including:

- An indexation of FIRB thresholds to ensure only true large corporate exposures are measured using the FIRB approach.
- Consideration of AIRB and FIRB collateral types and eligibility criteria to diminish the cliff effect of some customers being measured under FIRB.

2) Transitional arrangements for calculation of the capital floor – Market Risk

A further issue that the ABA would like to take this opportunity to comment on, given APRA are conducting minor upgrades to the capital standards would be to update the transitional arrangements for the calculation of the capital floor – Market Risk.

Under APS 110, ADIs which use their own internal models to estimate capital requirements are required to calculate a capital floor using risk weighted assets calculated under the Standardised approaches (APS 110, Attachment A, para 4). A transitional arrangement exists for market risk which allows ADIs to calculate the capital floor using the internal model approach rather than the standard method. This transitional arrangement is due to expire on 1 January 2025.

The ABA believe there would be value in extending this transitional arrangement to align to the implementation of the Fundamental Review of the Trading Book (FRTB) for the following reasons:

- APRA has previously communicated that FRTB will be implemented in 2026. Extending the transitional arrangement to align to the FRTB implementation date will prevent volatility in the capital floor measurement due to changes in regulatory approach within a short timeframe; and
- A number of ADIs do not have robust calculators to determine the risk weighted assets under the Standardised approach. Investment in developing a robust standardised RWA calculation for the current Market Risk standard will divert resources from FRTB implementation; and

- Market Risk RWA is a relatively small proportion of an ADI's overall RWA requirement (2 per cent).[3] Maintenance of the transitional arrangements will not have a material impact on the overall floor calculation.

The ABA recommend:

- Extending the transitional arrangement provided under APS 110, Attachment A, paragraph 5 until such time the FRTB approach becomes effective in Australia.

3) Comparable direct exposure

Australian ADIs use eligible credit risk mitigation as a key tool form managing credit risk portfolios. The previous APS 113 Attachment B paragraph 43 was interpreted to read that a comparable direct exposure allowed for a risk transfer which provided for a substitution of PD and change of asset class to that of the insurer, guarantor or CDS provider. In cases where insurance or guarantees were held and the underlying transaction was secured, the same LGD was applied as the underlying transaction in cases where there was the same access to collateral under this arrangement – not subrogating collateral rights under the insurance, guarantee or CDS.

Revisions to APG 113 specifically clarified that where an ADI substitutes PD to reflect credit risk mitigation instruments, the comparable direct exposure must be determined as an unsecured claim on the credit risk mitigation provider. As a result, the capital requirements for facilities covered by credit insurance attract the RWA associated with an unsecured exposure to the insurer (i.e. based on a 50 per cent LGD), even where ADIs still retain rights to any underlying loan collateral.

The European Banking Authority (EBA) recently released Article 161 of draft CRR3 standards proposing to allow LGD to be recognised. ABA is seeking APRA's reconsideration on the current APS current treatment with a request to align with the EBA approach detailed in Article 161. This change will provide APRA regulated ADIs with the same capital efficiency that our European peers will have in managing their overall risk positions.

[3] Average across the 4 major banks for 30 September 2023