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APRA Consultation: Revisions to the Capital Framework

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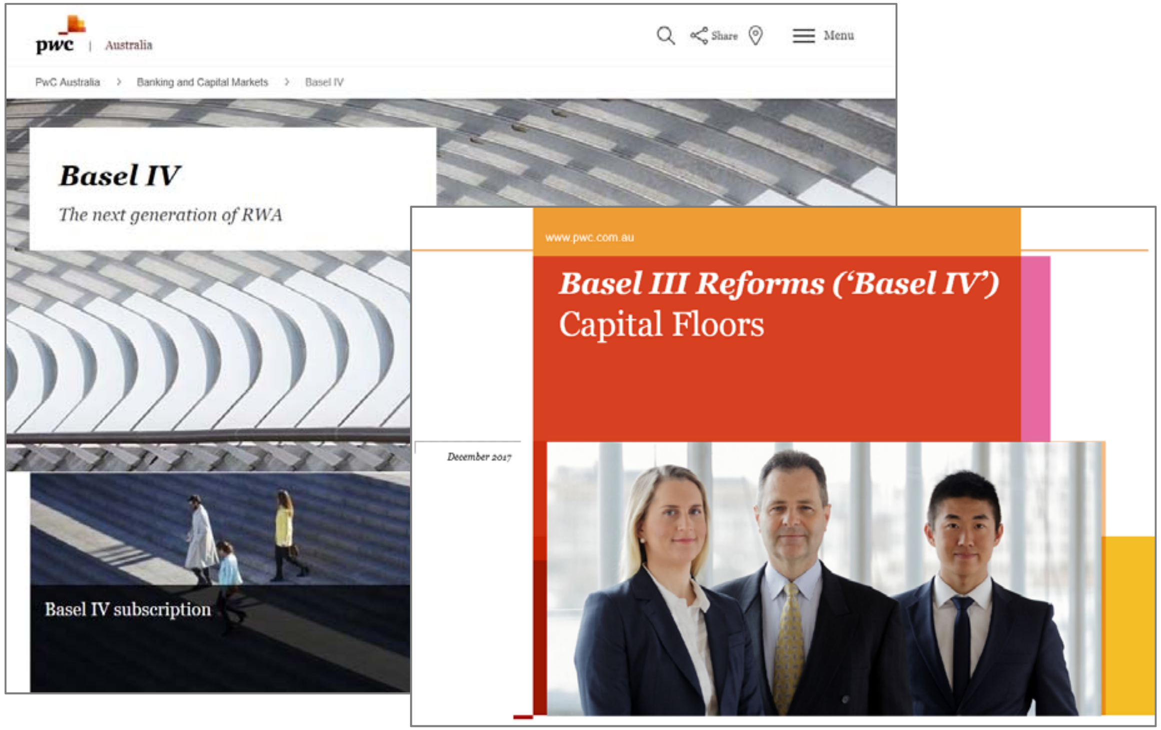
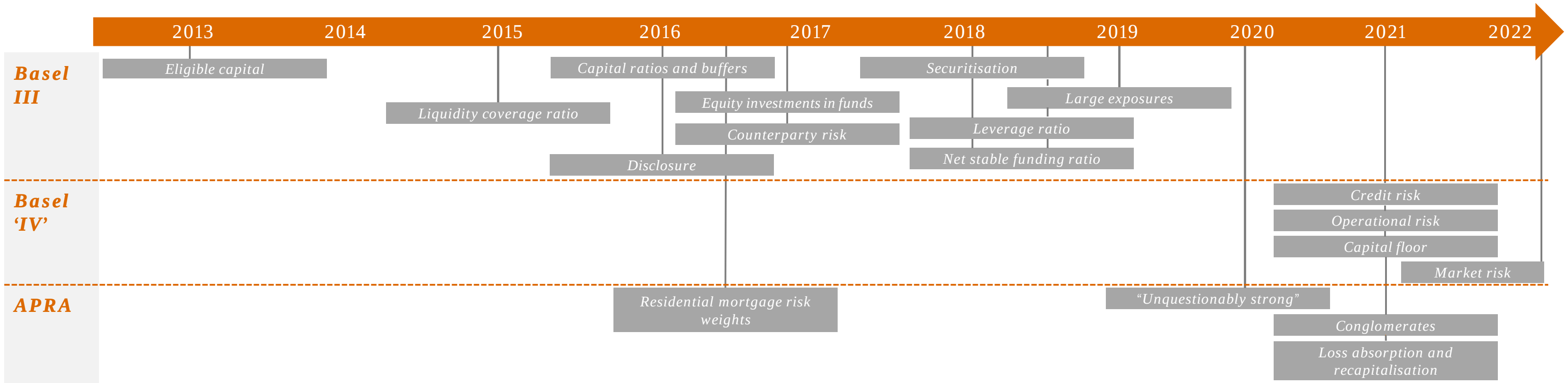


Webinar 5

- *Timetable and APRA policy priorities*
- *Credit Risk*
- *Operational Risk*
- *IRRBB, FRTB and CVA*

Timeline



APRA policy priorities 2018

	1st half 2018	2nd half 2018	2019
Conceptual framework for Basel III capital and other changes	Consult →		Finalise
Counterparty credit risk (APS 180)	Finalise		Implement
SA – Credit Risk (APS 112)		Consult	Consult and Finalise
IRB – Credit Risk (APS 113)		Consult	Consult and Finalise
Measurement of Capital (APS 111)	Consult →		Finalise

? Key APRA Question

1.2 What are the advantages of aligning the proposed changed with the Basel Committee's implementation date of January 2022

Credit Risk

Operational requirements
A challenge for SA and IRB banks

Parts of the mortgage practice guide are moving into the prudential standards, significantly bolstering the operational requirements defined by Basel. There are in the 'Ability to Repay' metrics. Specifically:

Ability to Repay	
Basel	'Must have underwriting policies that include metrics to assess repayment ability'
APRA	• Must have a 2% interest rate buffer and 7% floor when assessing serviceability. • Must verify that a borrower is able to service the loan on an ongoing basis (i.e. positive net income surplus); and • Approve the loan within the ADI's loan serviceability policy.

The first of these, and potentially the third, should be relatively consistent with current market practice in Australia, but the requirement to verify serviceability of an ongoing basis may be a significant challenge.

By moving this from guidance to a prudential standards APRA increases its power to enforce its responsible lending agenda.

The Basel standards are deliberately vague on how regulators implement the 'Ability to Repay' operational requirement, after early attempts to codify it were strongly rejected by the industry, and APRA's approach will be no surprise to those following the responsible lending agenda, but banks need to address their ability to meet the strong requirements at an early stage. System changes, and lending processes may need to be addressed early to minimise the impact of non-complying loans in 2021.

Failure to comply moves any loan to 100% RW. For SA and IRB banks.

? ***Key APRA Question***

2.1 How should sound underwriting be embedded in the capital framework?

Operational requirements

Proposed		
1	*Completed property*	• No construction loans
2	*Legal enforceability*	• Claim on property can be enforced within a reasonable time
3	*First lien*	• Lender must have 1st charge on property • 2nd charge acceptable if lender can initiate sale of property at a reasonable price
4	*Repayment ability*	• Borrower's ability to repay is assessed at underwriting • Minimum 2% buffer was used in serviceability • Borrower was assessed to be able to pay on an ongoing basis (net income surplus) • Loan is approved within existing serviceability policy • No "very high" income multiples
5	*Valuation*	• Prudent independent valuation of property • No subsequent value indexation unless its downward
6	*Documentation*	• All underwriting and monitoring information is documented and retained
7	*Loan complexity*	• No reverse mortgages • No SMSF mortgages
Existing		
1	*Repayment ability*	• Documented, assessed, verified borrower repayment ability, or • Borrower has substantially met payment obligations for 36 months
2	*Valuation*	• The ADI has valued the residential property • Property is revalued in case of material market value change
3	*Marketability*	• Property is readily marketable

Residential mortgages – New categories for SA and IRB

The rise of the prudent homeowner

Category		Standard Approach	IRB Banks
Lower Risk	P&I Owner Occupier loans.	Generally lower risk weights than existing	Lower correlation factor
Higher Risk	Interest Only loans. Investor Loans. SME loans back by Residential property (SA only).	Generally higher risk weights than existing, some very material.	Higher correlation factor
Non-compliant		100% Risk Weight	

A-IRB banks can also apply to have the LGD floor moved to 10% in 2018

IO loans are moved to 'Higher Risk', along with Investor loans and SME loans backed by residential property.

APRA have moved away from the IPRE concept used by Basel, largely to bring IO OO loans into this category. This impacts IRB and SA banks, albeit via different methods, but the overall preferential capital treatment for P&I Owner Occupier loans is consistent. It's consistent with APRA's on-going focus on IO loans, but is it the best way to move the dial on the balance of IO vs P&I loans. This is a significant variance which will make international comparability difficult.

Multiplied by a scalar to meet APRA capital targets.

? ***Key APRA Question***

2.5 Are there alternatives… that would similarly address APRA's concerns about higher risk lending?

Residential risk weights

Standard Approach

LVR %	Existing		Proposed		
			Standard loans		
	Standard loans	Non-standard loans	Lower risk • Owner occupied P&I	Higher risk • Investment • IO • SME loan	Non-standard loans
<50	35	35	20	30	100
50< >60	35	35	25	35	100
60< >80	35	50	30	45	100
80< >90	35	75	40	60	100
90< >100	50	75	50	75	100
100<	75	100	70	85	100

Legend Lower | Same | Higher

Changes to SME and CCFs

SME Changes

Category	Current (APS 112)	Basel Proposal	APRA Proposal	
Approach	**Standardised Approach**			**IRB**
Secured by Property	Risk weighted in the range 35-100% (based on LVR % and Std vs Non Std classification)	Treatment similar to property-secured exposure to any counterparty	Treatment similar to high risk category Residential mortgages (discussed earlier)	Treatment per IRB residential mortgages (discussed earlier)
Not secured by Property	*Risk weighted at 100%*	• Retail SME (Exposures < Euro 1m) – 75 % Risk weighted • Corporate SME (Consolidated sales < Euro 50 m) – 85% Risk weighted	• No branching into Retail and Corporate categories • Uniformly risk weighted at 85% (reduction from existing 100%)	• Merger of SME Retail and SME Corporate into a single SME asset class • Treatment per Corporate category

Scaled by firm-size adjustment factor

APRA have basically removed the SME IRB banks, and shifted part for the SA banks.

The net result is probably a lower RW for those loans backed by residential property, and a slightly lower result too for other SME loans. The impact for IRB banks is harder to quantify, but at least reduces one asset class, and the headache of moving commercial exposure from one bucket to another as the firm size moves around.

Changes to SME and CCFs

CCFs – A major sting for SA banks

Commitment Definition:
APRA has proposed to adopt the Basel III definition of 'commitment' which implies – any credit exposure that has been offered by an ADI and accepted by the borrower, including any unconditionally cancellable arrangement.

The proposal also aligns the credit conversion factors (CCFs) applicable to 'commitments' of standardised and advanced (IRB) ADIs, with a view that underlying borrower behaviour is not different for equivalent products.

Facility	APS 112 (%)	Basel Proposal (%)	APRA Proposal (%)
Other commitments – Maturity < 1 year	20	40	Bank, sovereign, credit cards (incl. undrawn limits): 50 Other exposures (including residential mortgages): 100
Other commitments – Maturity > 1 year	50	40	Bank, sovereign, credit cards (incl. undrawn limits): 50 Other exposures (including residential mortgages): 100
Other commitments – Unconditionally cancellable	0	10	20

? Key APRA Question

3.1 Should CCFs be aligned between standardised and IRB ADIs?

Residential IRB model inputs

Correlation factor range

Asset Class	APS 113 (%)	Basel III (%)	APRA Proposal
Residential mortgages	15% (effectively 25%)	15%	OO P&I: 15-22% Other: 20-27%
SME Retail	Secured on residential property: 15% Other: 3 – 16%	Secured on residential property: 15% Other: 3 – 16%	Remove asset class. Move to SME Corporate with input size adjustment.

LGD (A-IRB)

Asset Class	APS 113 (%)	Basel III (%)	APRA Proposal
Mortgages	20%	5%	10%
Other retail		Commercial or residential property – 10%	Commercial or residential property – 10%

Other IRB proposals

Constraints in modelling; end of slotting for commercial property

Constraints to IRB modelling

1. Corporate , Banks and Financial institutions asset classes move from Advanced IRB to Foundation IRB
2. Proposed F-IRB LGD estimates for secured lending are lower than APS 113 but higher than Basel III proposal
3. APRA determined EAD estimates for Non-retail and Retail non-revolving. Consistent with Standardised approach discussed before.

Asset class	APS 113 (%)	Basel Proposal (%)	APRA Proposal (%)
Commercial Property	Supervisory slotting approach	N/A	Land acquisition, development, construction: 28 to 35 Other exposures: 23 to 30
Qualifying revolving retail	*4*	4	Removal of asset class – moved to other retail
SME Retail	*Residential property secured: 15* *Other: 3 to 16*	Residential property secured: 15 Other: 3 to 16	Removal of asset class – moved to relevant non-retail correlation (discussed earlier)

? Key APRA Question

4.2 Should APRA allow IRB banks to use an IRB risk-weight function for commercial property exposures or continue with the supervisory slotting approach (assuming overall capital requirements would be comparable)?

4.3 What would be the impact of removing the SME retail and qualifying revolving retail asset classes from the IRB approach?

Operational Risk

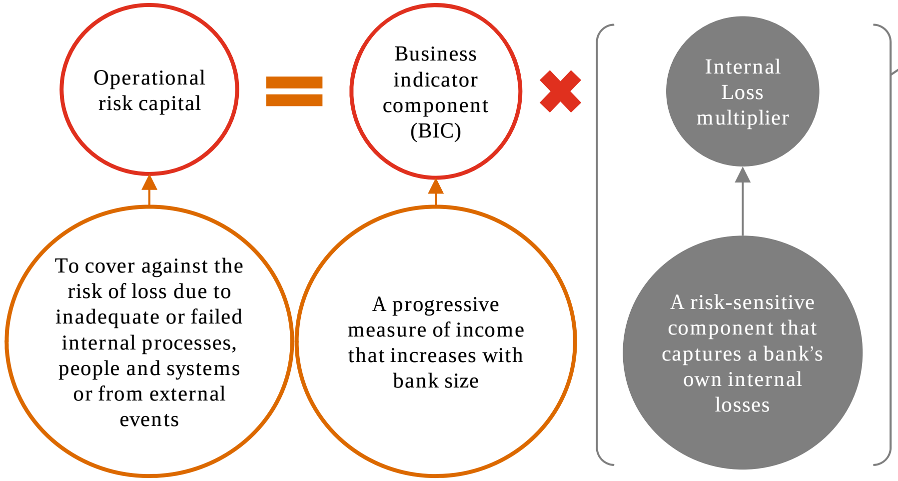
Changes to Operational Risk

Its no longer advanced…

- As part of Basel III reforms, Advanced Measurement Approach (AMA) and other Basel II standardised approaches were replaced with a new Standardised Measurement Approach (SMA).
- The SMA bases the operational risk capital requirement on a business indicator component (BIC) multiplied by a Loss component multiplier (which is discretionary on the part of national supervisors)

APRA proposes to exercise its national discretion to NOT implement the loss component, and instead set the operational risk requirement equal to the BIC for all ADIs

The new standardised approach



Proposed exclusion by APRA

? *Key APRA Question*

5.1 Should the loss component be omitted from the operational risk capital calculation?

IRRBB, FRTB and CVA

IRRBB, Market risk and CVA

A bit more change than expected, and a warning for large non advanced ADI's

APRA proposes to retain the minimum capital requirement (Pillar 1) for IRRBB but proposes measures to reduce variability and volatility in RWA and tweaks reporting requirements for larger standardised ADIs.

Areas	APS 117	Proposed
Non-interest bearing deposits	ADI determined assumptions	Provided by APRA
Basis risk	Internal modelling	Provided by APRA
Optionality risk	Internal modelling	Provided by APRA
Reporting	IRRBB capital requirements as on last day of each quarter	Average of (monthly or weekly) calculations over the quarter
	• All ADIs (advanced and standardised) report ARS 117.0 – Repricing analysis to APRA	• Proposal to standardise repricing assumptions in ARS 117.0 • Advanced and larger standardised ADIs to report IRRBB calculations per Basel Standardised framework to APRA
Disclosure (APS 330)	• IRRBB RWA calculations • Stress results based on EVE	To report • Stress results based on both NII and EVE measures, • Calculations based on standardised framework, • Model assumptions, • IRRBB objectives and management approach

? Key APRA Question

6.1 Would standardising assumptions for the non-interest bearing deposits portfolio and the basis and optionality risk calculations significantly reduce the benefit of having an internal model approach for IRRBB?

Larger standardised ADIs under APRA scanner

IRRBB, Market risk and CVA

Few changes now but more to come...

FRTB

- Status quo
- Finalisation of rules by Jan 2020
- Implementation date of 1st January 2022
- Consultations to water down the original proposal

CVA

- Basel III CVA framework is finalised but will be recalibrated inline with FRTB finalisation
- New standardised approach based on CVA sensitivities calculated by bank's internal models (Currently APS 112 outlines the existing basic approach)

Some key messages

APRA are not afraid to make big changes.

Early adoption is proposed for 2021.

Operational requirements for Residential loans may be the biggest challenge.

Risk approach and alignment between similar exposures, regardless of the banks models.

Credit Card portfolios may hit SA banks materially.

LGD floors can be dropped to 10%, and the end of Supervisory Slotting – both big steps to increase global harmonisation

Capital may not change, but ratios probably will. Be ready to manage the message to investors.

What's next?

QIS is out now or very soon. Invite only, but you can ask to join

- Accelerates your impact analysis
- Gives you a seat at the table in future consultations

Lots more from APRA, including speeches from Wayne Byers on a regular basis. We will keep you up to date via emails and website. Register at: pwc.com/basel-iv

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