

**Senate Economics Legislation Committee**

**ANSWERS TO QUESTIONS ON NOTICE**

**Treasury Portfolio**

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2014 - 2015

**Department/Agency: APRA**

**Question: AET 323-334**

**Topic: Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk**

**Reference: written - 11 March 2015**

**Senator: Dastyari, Sam**

**Question:**

323. What does APS113 regulate?
324. When was APS113 introduced?
325. Why was APS113 introduced?
326. What kind of business would be affected by this threshold?
327. Has the level (AU\$1m) been subject to internal APRA review since 2008?
328. Has the level (AU\$1m) been subject to public review or consultation since 2008?
329. Has APRA recommended the level (AU\$1m) to be lifted?
330. Have small business advocates or peak bodies recommended the level (AU\$1m) to be lifted?
331. Has APRA recommended APS113 be indexed to CPI or any another index?
332. Have small business advocates or peak bodies recommended APS113 be indexed to CPI or any another index?
333. Can you please advise how many small business, small business advocates, or peak bodies have contacted APRA to either complain, or recommend changes to the level and indexation of APS113?
334. Have any small business advocates or peak bodies suggested the government increase the AUD\$1 million threshold of APS113 to AUD\$3 million and index to CPI?

**Answer:**

323. *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113) sets out the requirements that must be met by an authorised deposit-taking institution (ADI) that has approval to use an internal ratings-based (IRB) approach to credit risk for regulatory capital purposes. The key requirements in APS 113 are that an ADI must: quantify certain credit risk components (such as the probability of default and loss-given-default) to determine the capital requirement for a given credit exposure; and have approval from the Australian Prudential Regulation Authority (APRA) to use an IRB approach for determining its credit risk capital requirement. Those requirements must be met both at the time of initial implementation and on an ongoing basis.

Five ADIs have obtained approval from APRA to use the IRB approach for regulatory capital purposes and, as such, are subject to the requirements of APS 113.

324. APS 113 was introduced on 1 January 2008.

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325. APS 113 was introduced as part of the implementation of the Basel II capital adequacy regime (known as the Basel II framework) in Australia. The Basel II framework was a major global reform of capital adequacy requirements for banks initiated by the Basel Committee on Banking Supervision. The framework aims to strengthen the soundness and stability of the international banking system by: better aligning capital requirements with the individual risk profile of banks; lessening regulatory arbitrage opportunities; and offering greater flexibility for supervisors, where appropriate, to encourage the use of more sophisticated risk management techniques.

With the implementation of the Basel II framework, APRA's requirements for ADIs to hold capital against small business loans have in general fallen substantially.

326. A \$1 million boundary exists under the IRB approach between lending classified as retail or corporate. Small businesses in the retail category would be in a range of industries, typically property, services, trade and agribusiness.

The retail/corporate boundary is a Basel II requirement and is set in the Basel II framework at €1 million. Minimum capital requirements increase as the boundary is crossed, other things being equal. An additional requirement is that for small business loans to be classified as retail, the exposures must be treated in a manner similar to other retail exposures in the ADI's internal risk management systems, including in respect of loan origination and ongoing management processes.

APRA originally converted the €1 million boundary to \$1 million as this lower level was considered more in keeping with market practice at the time. Indeed, until very recently, some ADIs had set limits lower than \$1 million on what constituted retail lending processes.

Above \$1 million, the IRB approach incorporates a size adjustment such that capital requirements are progressively discounted for loans to smaller businesses (with the discount factor tapering off for businesses with annual sales above \$50 million).

The retail/corporate boundary does not preclude ADIs using the IRB approach from implementing retail-like lending processes for loans in excess of \$1 million. Retail-like processes, however, generally become inappropriate as loan size and complexity increase.

327. The retail/corporate boundary has been subject to internal APRA review. As a result of that review, APRA noted in its first round submission to the Financial System Inquiry that it would be willing to consult on raising the \$1 million retail/corporate boundary to \$1.5 million, which would bring it into line (at current exchange rates) with the Basel II framework.

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328. The retail/corporate boundary was subject to public comment as part of the recent Financial System Inquiry.
329. In its submission to the Financial System Inquiry, APRA noted that there appears to be little compelling evidence to conclude that APRA's capital requirements significantly affect the prudent availability of lending to small business in terms of overall amount, cost or type. That said, APRA would be willing to consult on raising the \$1 million retail/corporate boundary to \$1.5 million, which would bring it into line (at current exchange rates) with the Basel II framework. However, ADIs under the IRB approach would still need to demonstrate that the other qualitative criteria in APS 113 are met before any loans involved could receive retail capital treatment. In particular, ADIs would need to apply retail-like lending processes to this segment of the market, while also ensuring that the processes are commensurate with the risk and complexity of the relevant exposures. As is the case for the current boundary, not all exposures up to \$1.5 million are likely to be considered suitable for retail-like lending processes; for more complex products or customers, a more tailored and individualistic approach would be needed and prudent.
330. Industry has approached Government on the potential to increase the \$1million retail/corporate boundary and APRA has responded to Government that there may be scope to increase the level, but not materially if broad consistency with internationally agreed bank regulation standards is to be maintained. This is consistent with APRA's submission to the Financial System Inquiry noted above.
331. APRA has not recommended that the \$1 million retail/corporate boundary be indexed to CPI or any other index. Indexation of the boundary is not part of the Basel II framework. That said, this would not preclude the Basel Committee on Banking Supervision from reviewing the appropriateness of the boundary from time to time.

As noted above, the boundary was set at \$1 million as this level was considered more in keeping with market practice at the time. Additionally, until very recently, some ADIs had set limits lower than \$1 million on what constituted retail lending processes.

332. APRA is not aware of industry bodies suggesting indexation of the \$1 million retail/corporate boundary. However, there has been acknowledgement that this amount was set some years ago. APRA notes the intention of the amount is to establish a general threshold and was not intended to be changed frequently. This in fact may not be helpful to industry as the boundary would be continually moving causing some uncertainty and is likely to lead to frequent management and reporting changes by lenders. Additionally the Basel Committee on Banking Supervision has not changed the €1 million amount since its introduction on 1 January 2008.
333. APRA has had direct engagement with industry bodies, including Council of Small Businesses of Australia (COSBOA) and by participating in small business finance

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forums arranged by the Reserve Bank of Australia. These engagements have been predominantly focussed on access to finance for small businesses, rather than specifically on the \$1m retail/corporate boundary. In these engagements it has been generally accepted that APRA's prudential requirements are not a material consideration in terms of access to finance. As noted above, APRA has also responded to industry concerns raised with Government.

334. APRA is aware that a finance broker association contacted Government suggesting an increase in the retail/corporate boundary to \$3 million. APRA provided input to Government to respond.