Senate Economics Legislation Committee

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates 30 May – 1 June 2006

Question: bet 114 (APRA)

Topic: **Modelling of alternative products to traditional mortgage insurance**

Hansard Page: **E114**

Senator CHAPMAN asked:

How are alternative products to traditional mortgage insurance, such as credit default swaps or financial guarantees, valued in your current modelling process?

Dr Laker—There are a set of risk weights for handling that. They are very technical. If you want a very detailed exposition of the calculation of credit default swap treatments, I will give it to you, but I will take it on notice.

Answer:

Under the Basel Capital Accord, established by the Basel Committee on Banking Supervision and adopted by most countries (including Australia), only select forms of credit risk transfer mechanisms are eligible to be recognised for capital purposes. In the event that a risk transfer mechanism is permitted, the risk-weight of the party providing the credit protection is required to be used in calculating risk-weighted assets for capital purposes. The risk-weight of a party is determined by a weighting of riskiness assigned to entities, ranging from a nil weighting for government to 100 per cent weighting for commercial enterprises. Parties are classified into broad groupings of risk-weights under the Basel Capital Accord and the risk-weights applied by APRA are consistent with those applied under the Accord. The larger the risk-weighting the greater the amount of capital which would need to be held by an authorised deposit-taking institution (ADI).

Under the Basel Capital Accord, guarantees and credit derivatives are accepted as a mechanism for transferring risk from one entity to another but insurance contracts are generally not accepted as eligible risk transfer mechanisms for capital purposes. For example, Paragraph 11 of *Guidance Note AGN 112.1 Risk-Weighted On-Balance Sheet Exposures* (**AGN 112.1**) states that only

- *guarantees* provided by the Commonwealth, State, Territory and Local Governments (including State and Territory central borrowing authorities) in Australia; central, state and local governments in OECD countries; public sector entities in Australia and OECD countries; OECD central banks and other OECD banks; ADIs in Australia; international agencies and multilateral regional development banks; and

- *credit derivatives* used for buying credit protection

will be recognised as eligible risk transfer mechanisms for capital adequacy purposes.

Attachment A to AGN 112.1 outlines the risk-weights applicable to counterparties to credit exposures held by the ADI. Exposures (including those arising from risk transfers) to OECD governments (including the Commonwealth Government) receive a zero risk-weight, OECD banks (including Australian ADIs) receive 20 per cent risk-weight and exposures to insurance companies receive a 100 per cent risk-weight.

Paragraph 22 of Attachment A applies a risk-weighting of 20 per cent to guarantees with ADIs in Australia. As noted above, insurance contracts are not recognised for risk transfer purposes but, even if they were, a claim covered by an insurance contract with an insurer would receive a 100 per cent risk-weight.

Under the existing *Guidance Note AGN 112.4 Treatment of Credit Derivatives in the Banking Book* (AGN 112.4), and consistent with international regulatory practice, credit derivatives are recognised for risk transfer purposes. The risk-weighting applied after the application of a credit derivative risk transfer would depend on the risk-weight applied to the protection seller. Where the protection seller is an OECD bank, the risk-weight applied for credit derivatives would be 20 per cent; where the seller is an insurance company, the risk-weight applied would be 100 per cent.

Attachment C to AGN 112.1 states, broadly in line with the requirements in the Basel Capital Accord, that loans for housing or other purposes to an individual, which are fully secured by registered mortgage over a residential property (whether or not the property is owned by the borrower), are eligible for a concessional risk-weight of 50 per cent. A number of countries, including Australia, have also imposed conditions in order for the concessional risk-weight to be applied. The eligibility conditions take the form of lending and loan-to-valuation criteria outlined in the Attachment.

Paragraph 11 of Attachment C states that the concessional 50 per cent risk-weight is available where the loan meets the lending criteria but not the loan-to-valuation criteria, provided the loan is 100 per cent mortgage insured through an acceptable lenders mortgage insurer. In essence, the presence of lenders mortgage insurance (LMI) in these circumstances functions as a concession to allow a borrower to offset any excess over loan-to-valuation requirements so that such loans can satisfy the criteria for a 50 per cent risk-weighting. LMI is not itself recognised as a risk transfer mechanism for capital purposes and, as such, ADIs are currently not required to include any potential exposures to insurers arising from LMI in their credit risk concentration measures.

The effect of the current provisions is:

(a) on-balance sheet claims secured by guarantees and credit derivatives are subject to a risk-weighting derived from the protection seller's creditworthiness; and

(b) loans secured via LMI are subject to a risk-weighting of 50 per cent.

If lenders mortgage insurance were to be treated as a "guarantee", it would currently receive a 100 per cent risk-weight. This is equivalent to a housing loan which did not meet the conditions for a concessional 50 per cent risk-weight. In addition, where an ADI recognised such a "guarantee" for capital purposes, it would be required to record its exposure to the insurer providing the LMI in its measure of credit risk concentration.

In line with international regulatory practice, APRA applies limits to an ADI's concentration of credit risk. Limits are applied, relative to an ADI's capital, on the total amount of credit exposure an ADI can have to another entity or group of related entities. Limits on credit concentration risk would include any exposures an ADI had to another entity by way of on- and off-balance sheet transactions, including exposures arising from risk transfer arrangements (eg guarantees and credit derivatives). Exposures to individual entities are *not* risk-weighted for the purposes of APRA's concentration limits. Currently, exposures to external parties (other than governments, ADIs and overseas deposit-taking equivalents) are limited to 25 per cent of an ADI's capital base. This would include any exposures to an insurance company. An ADI's exposures to other ADIs or overseas deposit-taking equivalents are limited to 50 per cent of an ADI's capital base.

As part of the global implementation of the Basel II Capital Accord, APRA has indicated that it will make a number of changes to the capital requirements applied to ADIs in Australia. For those ADIs calculating their capital adequacy under the so-called "standardised" approach:

(a) insurance contracts will remain ineligible credit risk transfer mechanisms;

(b) loans meeting the eligibility criteria for loans secured by mortgages over residential property (including those secured via LMI) will be subject to a risk-weighting of 35 per cent (paragraph 13 of Attachment D to the new *AGN 112.1 Standardised Approach to Credit Risk: Risk-weighted On-balance sheet Credit Exposures* (**new AGN 112.1**));

(c) the risk-weight of on-balance sheet claims covered by eligible risk transfer mechanisms such as guarantees and credit derivatives will continue to be replaced with the risk-weight of the protection seller. However, those counterparties which may provide an eligible credit risk transfer mechanism has been widened to include any the protection seller that has a certain external credit rating (per the requirements of the new AGN 112.1 and *AGN 112.3 Standardised Approach to Credit Risk: Simple Approach to Credit Risk Mitigation*). Such sellers will typically have a risk weighting of 20 per cent. As a result of these changes, guarantees or credit derivative contracts provided by insurance companies which meet the external rating requirements will be eligible to be recognised and will also likely attract a 20 per cent risk weighting; and

(d) the limits on credit concentration risk will continue to apply.

The proposed changes to the prudential standards are yet to be finalised and may be subject to further change.