Guidance Note AGN 112.2

Standardised Approach to Credit Risk: Risk-weighted Off-balance Sheet Credit Exposures

1. This Guidance Note and its Attachments set out the procedures and requirements for calculating the risk-weighted amount of an authorised deposit-taking institution’s (ADI’s) off-balance sheet credit exposures under the standardised approach for capital adequacy purposes.

Scope

2. The risk-weighting process used for measuring an ADI’s off-balance sheet credit exposures covers all the ADI’s off-balance sheet business, including both market-related and non-market-related transactions.

Risk-weighted amount

3. An ADI’s total risk-weighted off-balance sheet credit exposure is calculated as the sum of the risk-weighted amount of all its market-related and non-market-related transactions.

4. The risk-weighted amount of an off-balance sheet transaction that gives rise to credit exposure is generally calculated by means of a two-step process:

   (a) first, the notional amount of the transaction is converted into an on-balance sheet equivalent (i.e. credit equivalent amount) by multiplying the amount by a specified credit conversion factor; and

   (b) second, the resulting credit equivalent amount is multiplied by the risk-weight (refer AGN 112.1 Standardised Approach to Credit Risk: Risk-weighted On-balance Sheet Credit Exposures) applicable to the counterparty or type of asset. Where the transaction is secured by eligible collateral, guarantee or credit derivative, the credit risk mitigation techniques detailed in AGN 112.3 Standardised Approach to Credit Risk: Simple Approach to Credit Risk Mitigation, AGN 112.4 Standardised Approach to Credit Risk: Comprehensive Approach to Credit Risk Mitigation and AGN 112.6 Standardised Approach to Credit Risk: Treatment of Credit Derivatives in the Banking Book may be used to reduce the regulatory capital charge of the exposure.
5. An ADI must consult APRA in case of doubt about the risk-weighted amount of a particular off-balance sheet transaction.

Non-market-related off-balance sheet transactions

6. The credit equivalent amount in relation to a non-market-related off-balance sheet transaction referred to in Attachment A to this Guidance Note (these transactions are broadly categorised into direct credit substitutes, trade and performance related contingent items and other commitments) is determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor specified in the Attachment.

7. Where the non-market-related off-balance sheet transaction is an undrawn or partially undrawn facility, the amount of undrawn commitment to be included in calculating an ADI’s off-balance sheet non-market-related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms part of an ADI’s on-balance sheet credit exposure.

8. With regard to irrevocable commitments to provide off-balance sheet facilities, the original maturity will be measured from the commencement of the commitment up until the time the associated facility expires. For example, an irrevocable commitment, with an original maturity of six months, to provide finance with a nine-month term, is deemed to have an original maturity of 15 months.

9. Irrevocable commitments to provide off-balance sheet facilities should be assigned the lower of the two applicable credit conversion factors. For example, an irrevocable commitment with an original maturity of six months to provide a guarantee in support of a counterparty for a period of nine months, attracts the 50 per cent credit conversion factor applicable to the commitment.

10. All commitments are to be included in the capital ratio calculation regardless of whether or not they contain “material adverse change” clauses or any other provisions which are intended to relieve an ADI of its obligations under certain conditions.

11. For any non-market-related off-balance sheet transaction that gives rise to credit risk, but is not specifically identified in Attachment A, an ADI must consult APRA on the appropriate credit conversion factor to be used for calculating the credit equivalent amount of that particular transaction for capital adequacy purposes. APRA may, in writing, determine an appropriate credit conversion factor for the transaction (having regard to the risk entailed by the transaction and the credit conversion factors applicable to similar transactions).

Market-related off-balance sheet transactions

12. In calculating an ADI’s risk-weighted off-balance sheet credit exposures arising from market-related transactions for capital adequacy purposes, the ADI must
include all its market-related transactions held in the banking and trading books which give rise to off-balance sheet credit risk.

14. The credit risk on off-balance sheet market-related transactions is the cost to an ADI of replacing the cash flow specified by the contract in the event of counterparty default. This will depend, among other things, on the maturity of the contract and on the volatility of rates underlying that type of instrument.

15. Market-related transactions include the following:

(a) interest rate contracts - this includes single currency interest rate swaps, basis swaps, forward rate agreements, interest rate futures, interest rate options purchased and any other instruments of a similar nature;

(b) foreign exchange contracts (including contracts involving gold) - this includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options purchased, hedge contracts and any other instruments of a similar nature;

(c) equity contracts - this includes swaps, forwards, purchased options and similar derivative contracts based on individual equities or equity indices;

(d) precious metal contracts (other than gold) - this includes swaps, forwards, purchased options and similar derivative contracts based on precious metals such as silver, platinum and palladium;

(e) other commodity contracts (other than precious metals) - this includes swaps, forwards, purchased options and similar derivative contracts based on energy contracts, agricultural contracts, base metals (such as aluminium, copper and zinc) and any other non-precious metal commodity contracts; and

(f) other market-related contracts - this includes any contracts covering other items which give rise to credit risk.

16. Paragraph 15 of this Guidance Note does not intend to provide an exhaustive list of market-related transactions for capital adequacy purposes. An ADI should seek clarification from APRA where it is unclear as to which category is appropriate for a particular market-related transaction.

17. Exemption from capital weighting is permitted for:

(a) foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and

(b) instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments.

18. An ADI should not generally enter into contracts at off-market prices. This includes historical rate rollovers on foreign exchange contracts. In the case of
historical rate rollovers, an ADI must have a policy framework in place around
the granting and monitoring of historical rate rollovers. This policy framework
must be agreed with APRA. Transactions outside of the APRA agreed
framework must be discussed with APRA. APRA will determine, in writing,
the capital (and other prudential) treatment of these transactions.

19. An ADI may, for capital adequacy purposes, net off-balance sheet claims and
obligations arising from market-related contracts across both the banking and
trading books, arising from contracts with a single counterparty, where the
relevant obligations are covered by eligible bilateral netting agreements (refer
AGN 112.5 Standardised Approach to Credit Risk: Netting).

20. The credit equivalent amount of an off-balance sheet market-related transaction,
whether held in the banking or trading book, must be determined as follows:

(a) in the case of interest rate and foreign exchange (including gold) contracts:

   (i) by the current exposure (also known as the mark-to-market)
   method; or

   (ii) with APRA’s prior approval in writing, the original exposure
   (also known as the rule-of-thumb) method; and

(b) in all other cases, by the current exposure (mark-to-market) method.

Current exposure method

21. The credit equivalent amount of a market-related contract (not covered by an
eligible bilateral netting agreement) calculated using the current exposure
method is the sum of current credit exposure and potential future credit
exposure (the add-on) of these contracts (refer AGN 112.5 Standardised
Approach to Credit Risk: Netting for calculation of credit equivalent amount of
market-related contracts covered by eligible bilateral netting agreements).

22. Current credit exposure is defined as the sum of the positive mark-to-market
value (or replacement cost) of these contracts.

23. Potential future credit exposure is determined by multiplying the notional
principal amount of each of these contracts (regardless of whether the contract
has a zero, positive or negative mark-to-market value) by the relevant credit
conversion factor specified in Attachment B to this Guidance Note according to
the nature and residual maturity of the instrument.

24. The notional or nominal principal amount, or value, of a contract is the
reference amount used to calculate payment streams between counterparties to a
contract.

25. Potential future credit exposure should be based on effective rather than
apparent notional amounts. In the event that the stated notional amount of a
contract is leveraged or enhanced by the structure of the transaction, an ADI
must use the effective notional amount when calculating potential future credit exposure. For example, a stated notional amount of $1 million with payments based on an internal rate of two times the bank bill rate would have an effective notional amount of $2 million.

26. For contracts that are structured to settle outstanding exposures following specified payment dates and where the terms are reset such that the mark-to-market value of the contract is zero on these specified dates, then the residual maturity should be set equal to the time until the next reset date. In the case of interest rate contracts with these features with a remaining maturity of more than one year, the credit conversion factor to be applied is subject to a floor of 0.5 per cent even if there are reset dates of a shorter maturity.

27. For contracts with multiple exchanges of principal, the credit conversion factors are to be multiplied by the number of remaining payments (i.e. exchanges of principal) still to be made under the contract.

28. Contracts which do not fall within one of the five categories listed in Attachment B to this Guidance Note should be treated in the same way as “other commodities” contracts.

29. No potential future credit exposure is calculated for single currency floating / floating interest rate swaps; the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market value.

Original exposure method

30. Where the original exposure method is used, the credit equivalent amount of an off-balance sheet market-related contract is determined by multiplying the notional principal amount of the contract by the appropriate credit conversion factor specified in Attachment B to this Guidance Note according to the nature and original maturity of the instrument.
Attachment A

Credit conversion factors for non-market-related off-balance sheet transactions

<table>
<thead>
<tr>
<th>Nature of transaction</th>
<th>Credit conversion factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct credit substitutes</td>
<td>100%</td>
</tr>
</tbody>
</table>
| Any irrevocable off-balance sheet obligations which carry the same credit risk as a direct extension of credit, such as an undertaking to make a payment to a third party in the event that a counterparty fails to meet a financial obligation or an undertaking to a counterparty to acquire a potential claim on another party in the event of default by that party, constitutes a direct credit substitute (i.e. the risk of loss depends on the creditworthiness of the counterparty or the party against whom a potential claim is acquired).
| This includes potential credit exposures arising from the issue of guarantees and credit derivatives (selling credit protection), confirmation of letters of credit, issue of standby letters of credit serving as financial guarantees for loans, securities and any other financial liabilities, and bills endorsed under bill endorsement lines (but which are not accepted by, or have the prior endorsement of, another ADI). |                          |

Performance-related contingencies

Contingent liabilities which involve an irrevocable obligation to pay a third party in the event that a counterparty fails to fulfil or perform a contractual non-monetary obligation, such as delivery of goods by a specified date etc (i.e. the risk of loss depends on a future event which need not necessarily be related to the creditworthiness of the counterparty involved).

This includes issue of performance bonds, bid bonds, warranties, indemnities, and standby letters of credit in relation to a non-monetary obligation of a counterparty under a particular transaction.
### Nature of transaction

<table>
<thead>
<tr>
<th>Credit conversion factor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trade-related contingencies</strong></td>
</tr>
</tbody>
</table>
| Contingent liabilities arising from trade-related obligations which are secured against an underlying shipment of goods for both issuing and confirming ADIs.  
This includes documentary letters of credit issued, acceptances on trade bills, shipping guarantees issued and any other trade-related contingencies. |
| 20% |
| **Lending of securities or posting of securities as collateral** |
| The lending or posting of securities as collateral by ADIs. This includes repurchase/reverse repurchase agreements and securities lending/borrowing transactions\(^1\). |
| 100% |
| **Assets sold with recourse** |
| This includes any asset sales (to the extent that such assets are not included on-balance sheet) by an ADI where the holder of the asset is entitled to “put” the asset back to the ADI within an agreed period or under certain prescribed circumstances, e.g. deterioration in the value or credit quality of the asset concerned\(^3\). |
| 100% |

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\(^1\) These exposures may be treated as collateralised transactions as per the credit risk mitigation techniques detailed in AGN 112.3 Standardised Approach to Credit Risk: Simple Approach to Credit Risk Mitigation and AGN 112.4 Standardised Approach to Credit Risk: Comprehensive Approach to Credit Risk Mitigation.

\(^2\) Where an ADI, acting as an agent, arranges a repurchase/reverse repurchase or securities lending/borrowing transaction between a customer and a third party and provides a guarantee to the customer that the third party will perform on its obligations, then the risk to the ADI is the same as if the ADI had entered into the transaction as principal. In such circumstances, the ADI will be required to calculate capital requirements as if it, itself, was the principal.

\(^3\) These transactions are risk-weighted according to the type of assets or the issuer of securities (as appropriate) and not according to the counterparty with whom the transaction is made, where the credit risk associated with the underlying asset which has been sold (temporarily with recourse) or purchased, remains with the ADI.
Nature of transaction

Forward asset purchases

This includes commitments to purchase at a specified future date and on pre-arranged terms, a loan, security or other asset from another party, including written put options on specified assets with the character of a credit enhancement.

Where an ADI purchasing the asset has an unequivocal right to substitute cash settlement in place of accepting delivery of the asset and the price on settlement is calculated with reference to a general market price indicator (and not to the financial condition of any specific entity), the purchase may be treated as a market-related off-balance sheet transaction.

Written put options expressed in terms of market rates for currencies or financial instruments bearing no credit risk are excluded from risk assets.

Partly paid shares and securities

This includes any amounts owing on the uncalled portion of partly paid shares and securities held by an ADI which represent commitments with certain drawdown by the issuer at a future date.

Placements of forward deposits

This relates to any agreement between an ADI and another party whereby the ADI will place a deposit at an agreed rate of interest with that party at a predetermined future date.

Note issuance and underwriting facilities

This involves arrangements whereby a borrower may drawdown funds up to a prescribed limit over a predefined period by making repeated note issues to the market, and where, should the issue prove unable to be placed in the market, the unplaced amount is to be taken up or funds made available by an ADI being committed as an underwriter of the facility.
### Nature of transaction

#### Credit conversion factor

<table>
<thead>
<tr>
<th>Nature of transaction</th>
<th>Credit conversion factor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Other commitments</strong></td>
<td></td>
</tr>
<tr>
<td>(a) Commitments with certain drawdown.</td>
<td>100%</td>
</tr>
<tr>
<td>(b) Commitments (e.g. undrawn formal standby facilities and credit lines) with an original maturity of:</td>
<td></td>
</tr>
<tr>
<td>(i) one year or less.</td>
<td>20%</td>
</tr>
<tr>
<td>(ii) over one year.</td>
<td>50%</td>
</tr>
<tr>
<td>(c) Commitments that can be unconditionally cancelled at any time without notice (e.g. undrawn overdraft and credit card facilities providing that any outstanding unused balance is subject to review at least annually) or effectively provide for automatic cancellation due to deterioration in a borrower’s creditworthiness.</td>
<td>0%</td>
</tr>
<tr>
<td>(d) Irrevocable standby commitments provided under APRA’s approved industry support arrangements.</td>
<td>0%</td>
</tr>
</tbody>
</table>
### Attachment B

**Credit conversion factors for market-related off-balance sheet transactions**

**Current exposure method**

<table>
<thead>
<tr>
<th>Residual maturity</th>
<th>Interest rate contracts</th>
<th>Foreign exchange and gold contracts</th>
<th>Equity contracts</th>
<th>Precious metal contracts (except gold)</th>
<th>Other commodities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year or less</td>
<td>nil</td>
<td>1.0%</td>
<td>6.0%</td>
<td>7.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>&gt; 1 year to 5 years</td>
<td>0.5%</td>
<td>5.0%</td>
<td>8.0%</td>
<td>7.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>&gt; 5 years</td>
<td>1.5%</td>
<td>7.5%</td>
<td>10.0%</td>
<td>8.0%</td>
<td>15.0%</td>
</tr>
</tbody>
</table>

**Original exposure method**

<table>
<thead>
<tr>
<th>Original maturity</th>
<th>Interest rate contracts</th>
<th>Foreign exchange and gold contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year or less</td>
<td>0.5%</td>
<td>2.0%</td>
</tr>
<tr>
<td>&gt; 1 year to 2 years</td>
<td>1.0%</td>
<td>5.0% (i.e. 2% + 3%)</td>
</tr>
<tr>
<td>For each additional year</td>
<td>1.0%</td>
<td>3.0%</td>
</tr>
</tbody>
</table>