



Banking (prudential standard) determination No. 15 of 2007

Prudential standard APS 221 Large Exposures

Banking Act 1959

I, John Francis Laker, Chair of APRA:

- (a) under subsection 11AF(1) of the *Banking Act 1959* (the Act), DETERMINE *Prudential Standard APS 221 Large Exposures* in the form set out in the Schedule, which applies to all authorised deposit-taking institutions (ADIs); and
- (b) under subsection 11AF(3) of the Act, REVOKE *Prudential Standard APS 221 - Large Exposures* made by Banking (prudential standard) determination No. 8 of 2006.

This instrument takes effect on 1 January 2008.

Dated 11 December 2007

[Signed]

John Francis Laker
Chair

Interpretation

In this Determination

ADI has the meaning given in section 5 of the Act.

APRA means the Australian Prudential Regulation Authority.

Note 1 An ADI that does not comply with a standard may be issued with directions by APRA under paragraph 11CA(1)(a) of the Act. Non-compliance with a direction is an offence attracting a penalty of up to 250 penalty units for a body corporate (currently \$27,500) for each day that the offence continues. Officers of the ADI may also be criminally liable (see section 11CG).

Schedule

Prudential Standard APS 221 Large Exposures comprises the 7 pages commencing on the following page.



Prudential Standard APS 221

Large Exposures

Objective and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that ADIs implement proper measures and prudent limits to monitor and control their large exposures on both a stand-alone and group basis.

Authority

1. This Prudential Standard is made under section 11AF of the *Banking Act 1959* (**the Banking Act**).

Application

2. This Prudential Standard applies to all authorised deposit-taking institutions (**ADIs**) authorised under the Banking Act.
3. This Prudential Standard does not apply to foreign ADIs in Australia which are subject to the consolidated supervision by their home country supervisors in respect of credit concentrations and large exposure limits. However, foreign ADIs should detail their large exposure and risk concentration policies as well as the relevant high level controls in the risk management systems descriptions required under *Prudential Standard APS 310 Audit & Related Arrangements for Prudential Reporting*. As part of its prudential oversight of the Australian operations of a foreign ADI, APRA may discuss with the foreign ADI's parent and home supervisor any undue credit risk concentrations associated with the branch's Australian activities.

Control of large exposures and risk concentrations

4. An ADI¹ is exposed to various forms of risk concentration with the potential to incur significant losses that could materially threaten the ADI's financial strength. Risk concentrations may arise from excessive exposures to individual counterparties, groups of related counterparties, groups of counterparties with similar characteristics (e.g. counterparties in specific geographical regions or industry sectors) or to particular asset classes (e.g. property holdings or other investments). Safeguarding against risk concentrations to particular counterparties,² industries, countries and asset classes must form an essential component of ADI's risk management strategies.³
5. The Board of directors (**Board**) of an ADI is responsible for establishing, and monitoring compliance with, policies governing large exposures and risk concentrations of the ADI. The Board must ensure that these policies are reviewed regularly (at least annually) and that they remain adequate and appropriate for the ADI. Any material changes to established policies must be approved by the Board.

¹ A reference to an ADI in this Prudential Standard shall be taken as a reference to an ADI on a Level 1 basis and a group of which an ADI is a member on a Level 2 basis. Level 1 and Level 2 have the meaning in *Prudential Standard APS 110 Capital Adequacy (APS 110)*.

² As a general rule, unlimited exposures to any individual counterparties (e.g. a general guarantee of the obligations of a counterparty) are not permitted.

³ For the purposes of this Prudential Standard, the relevant policies and high level controls should be detailed in the ADI's risk management systems descriptions required under *Prudential Standard APS 310 Audit & Related Arrangements for Prudential Reporting*.

6. An ADI's large exposures policy must, as a minimum, cover the following:
 - (a) exposure limits for:
 - (i) various types of counterparties (e.g. governments, ADIs and foreign equivalents, corporate and individual borrowers);
 - (ii) a group of related counterparties;
 - (iii) individual industry sectors (where applicable);
 - (iv) individual countries (where applicable); and
 - (v) various asset classes (e.g. property holdings and other investments, etc.)that are commensurate with the ADI's capital base and balance sheet size;
 - (b) the circumstances in which the above exposure limits may be exceeded and the authority required for approving such excesses (e.g. by the ADI's Board or a board committee); and
 - (c) the procedures for identifying, reviewing, controlling and reporting large exposures of the ADI.
7. The Board and senior management of an ADI should ensure that:
 - (a) adequate systems and controls are in place to identify, measure, monitor and report large exposures and risk concentrations of the ADI in a timely manner; and
 - (b) large exposures and risk concentrations of the ADI are kept under regular review.
8. An ADI must, where appropriate, conduct stress testing and scenario analysis of its large exposures and risk concentrations to assess the impact of changes in market conditions or key risk factors (e.g. economic cycles, interest rate, liquidity conditions or other market movements) on its risk profile and earnings.

Definitions

9. A large exposure is an exposure to a counterparty or a group of related counterparties which is greater than or equal to 10% of an ADI's capital base.⁴
10. An exposure to a counterparty or a group of related counterparties is the aggregate of all claims, commitments and contingent liabilities arising from on-

⁴ The 10% threshold applies to an ADI's exposure at both Level 1 and Level 2 on a net basis (i.e. net of exposures excluded under paragraph 10(b) below). The ADI's capital base at Level 1 and Level 2 is measured in accordance with *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)*.

and off-balance sheet transactions (in both the banking and trading books) with the counterparty or group of related counterparties, and

- (a) includes, but is not limited to:
- (i) outstanding balances of all loans and advances;
 - (ii) holdings of debt and/or equity securities;
 - (iii) all unused advised off-balance sheet commitments (refer to Attachment B to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112)*), whether revocable or irrevocable; and
 - (iv) the credit equivalent amounts of all market-related contracts (calculated in accordance with Attachment B to APS 112 or Attachment I to APS 112 where netting applies⁵);
- (b) excludes:
- (i) exposures (e.g. claims or equity investments) deducted from an ADI's capital (refer *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*);
 - (ii) exposures to the extent that they are secured by cash deposits (subject to satisfying all the criteria applicable to transactions collateralised by cash as set out in Attachment G to APS 112 for the purpose of this Prudential Standard);
 - (iii) exposures to the extent that they are guaranteed by, or secured against securities issued by, governments or central banks (being the Australian government, foreign governments and central banks which receive a zero per cent risk-weight in accordance with Attachment A to APS 112 for the purpose of this Prudential Standard);
 - (iv) exposures arising in the course of settlement of market-related contracts;
 - (v) exposures to an ADI required as part of a liquidity support arrangement that has been certified by APRA,⁶ under section 11CB of the Act; and
 - (vi) exposures to the extent that they have been written off or specifically provided for.

⁵ For large exposure purposes, netting by novation and close-out netting are permissible for market-related contracts provided all the requirements set out in Attachment I to APS 112 for bilateral netting are met. Multilateral netting and netting of exposures against offsetting positions held by a group of related counterparties are not recognised for the purposes of this Prudential Standard.

⁶ Refer section 11CB of the *Banking Act 1959*.

11. A group of related counterparties should be deemed to exist where two or more individual counterparties are linked by:
- (a) cross guarantees;
 - (b) common ownership or management;
 - (c) the ability to exercise control over the other(s), whether direct or indirect;
 - (d) financial interdependency such that the financial soundness of any of them may affect the financial soundness of the other(s); or
 - (e) other connections or relationships which, according to an ADI's assessment, identify the counterparties as constituting a single risk.

As a general rule, family members are not to be treated as connected where they have independent retail relationships with an ADI (although an ADI can choose to treat such exposures as connected should it consider appropriate to do so).

Prudential limits

12. The aggregate exposure of an ADI to a counterparty or a group of related counterparties is subject to the following limits:⁷
- (a) external parties (other than governments, central banks and ADIs or equivalent overseas deposit-taking institutions) unrelated to the ADI – 25 per cent of capital base;
 - (b) unrelated ADI (or equivalent overseas deposit-taking institution) and its subsidiaries – 50 per cent of capital base, with aggregate exposure to non-deposit-taking subsidiaries capped at 25 per cent of capital base; and
 - (c) foreign parents and their subsidiaries⁸ – 50 per cent of capital base, with aggregate exposure to non-deposit-taking subsidiaries capped at 25 per cent of capital base.
13. Although certain types of exposure (e.g. settlement risk, exposure secured by eligible collateral) and counterparties (governments and central banks) are excluded from the above prescribed limits, these exposures are not risk free. ADIs should have adequate procedures and controls in place (e.g. by way of internal limits) to monitor these exposures.
14. ADIs should treat the 25 per cent limit as the upper limit for an exposure to a non-government, non-ADI counterparty. APRA expects ADIs to establish lower internal limits to any non-government, non-ADI counterparty commensurate with their risk appetite.

⁷ These limits apply to an ADI's exposure at both Level 1 and Level 2 on a net basis. The ADI's capital base at Level 1 and Level 2 is measured in accordance with APS 111.

⁸ Prudential limits on an ADI's exposures to other related entities are set out in *Prudential Standard APS 222 Associations with Related Entities*.

15. Notwithstanding paragraph 12, APRA may, in writing, set specific limits on an ADI's exposures to particular counterparties, groups of counterparties, industry sectors, countries or asset classes, including property holdings and any other investments, on a case-by-case basis, having regard to the ADI's individual circumstances.

Approval requirements

16. An ADI must obtain APRA's prior approval for any proposed exposures in excess of the prescribed limits set out in paragraph 12 or alternative limit determined under paragraph 15. Such approval will only be granted on an exceptions basis. The ADI concerned must be able to satisfy APRA why the proposed exposure(s) might reasonably be expected not to expose the ADI to excessive risk. APRA may impose a higher minimum capital ratio on the ADI at Level 1 and/or Level 2 (refer *Prudential Standard APS 110 Capital Adequacy (APS 110)*) to compensate for the additional risk that may be associated with the proposed exposure(s).

Notification requirements

17. An ADI must notify APRA immediately of any breach of the prescribed limits under paragraph 12 or other specific limits imposed by APRA under paragraph 15, including remedial actions taken or planned to deal with the breach.
18. An ADI must inform APRA immediately where it has concerns that its large exposures or risk concentrations have the potential to impact materially upon its capital adequacy, along with proposed measures to address these concerns.

Prior consultation requirements

19. An ADI must consult with APRA prior to committing to any proposed exposures to non-government, non-ADI counterparties in excess of 10% of its capital base.⁹
20. APRA may, in writing, set a higher consultation threshold or waive the prior consultation requirements for individual ADIs where APRA is satisfied with the robustness of the ADI's credit risk management systems and controls.

Concentration of risk

21. Where an ADI has a number of large exposures (excluding exposures set out in paragraph 10(b) and any exposure to governments and central banks) or where in APRA's opinion, the ADI is exposed to a significant level of risk concentration, APRA may require the ADI to maintain a higher capital ratio at Level 1 and/or Level 2 (refer APS 110). In considering whether an ADI's

⁹ The 10 per cent prior consultation requirement applies to any proposed exposures of an ADI at both Level 1 and Level 2 on a net basis (i.e. net of exposures excluded under paragraph 10(b) above). The ADI's capital base at Level 1 and Level 2 is measured in accordance with APS 111.

capital ratio should be increased, APRA will take account of the following factors:

- (a) consistency with the ADI's policy on large exposures and risk concentrations;
 - (b) the number of exposures, their individual size and nature; and
 - (c) the characteristics of the ADI, including the nature of its business and the experience of its management.
22. APRA may also direct an ADI to take measures to reduce its level of risk concentration.