

## **Banking (prudential standard) determination No. 4 of 2018**

### **EXPLANATORY STATEMENT**

**Prepared by the Australian Prudential Regulation Authority (APRA)**

*Banking Act 1959, Section 11AF*

Under subsection 11AF(1) of the *Banking Act 1959* (the Act), APRA has the power to determine standards (prudential standards), in writing, in relation to prudential matters to be complied with by authorised deposit-taking institutions (ADIs) and authorised non-operating holding companies (authorised NOHCs). Under subsection 11AF(3) of the Act, APRA may, in writing, vary or revoke a prudential standard.

On 23 August 2018, APRA made Banking (prudential standard) determination No. 4 of 2018 (the instrument), which revokes *Prudential Standard APS 221 Large Exposures* made under Banking (prudential standard) determination No. 5 of 2014 and determines a new *Prudential Standard APS 221 Large Exposures* (APS 221).

The instrument commences on 1 January 2019.

#### **1. Background**

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system. A key component of this is requiring ADIs to have prudent systems for identifying, measuring, evaluating, monitoring, reporting and controlling or mitigating material risks that may affect their ability to meet obligations to depositors.

APS 221 requires ADIs to implement prudent measures and to set prudent limits on their exposures (e.g. loans) to counterparties, to monitor and control their large exposures and risk concentrations. A risk concentration occurs when an ADI has a concentration of exposures to counterparties, industries, countries or particular asset classes. A large exposure is a type of risk concentration and is defined in APS 221 as an ADI's exposure to an individual counterparty or a group of connected counterparties that is greater than, or equal to, 10 per cent of the ADI's Tier 1 Capital.

The new APS 221 introduces more conservative prudential limits on exposures to counterparties and stronger requirements for measuring and aggregating exposures. Lower prudential limits are intended to limit large losses to the ADI when a counterparty defaults. Stronger requirements on exposure measurement and aggregation is intended to enhance the ability of ADIs to monitor and control systemic risks to which they are exposed. The new APS 221 is largely based on the Basel Committee on Banking Supervision's *Standards: Supervisory framework for measuring and controlling large exposures* (Basel large exposures

framework) that was finalised in April 2014.<sup>1</sup> Prior to this update, APS 221 was last materially updated in 2003.

## 2. Purpose and operation of the instrument

The purpose of the instrument is to revoke APS 221 and replace it with a new version of APS 221. The changes largely reflect the requirements of the Basel large exposures framework. Material amendments to APS 221 include:

- a reference to Tier 1 Capital as a basis for determining large exposures;
- a downwards recalibration of existing large exposure limits, and the introduction of a lower limit on exposures of a domestic systemically important bank (D-SIB) to another D-SIB. This will limit the degree of contagion risk which an ADI is exposed to; and
- a stronger set of requirements for measuring and aggregating exposure values, and disaggregating exposure values to underlying counterparties when an ADI is exposed to structured vehicles (e.g. funds, securitisation vehicles and structured finance products) which hold underlying assets. This will enhance the ability of ADIs to monitor and mitigate systemic risks which they are exposed to.

APS 221 incorporates by reference certain provisions of the *Banking Act 1959*, Prudential Standards, and Australian Accounting Standards issued by the Australian Accounting Standards Board. All of these references are references to the instruments as they exist from time to time. These instruments are available on the Federal Register of Legislation at [www.legislation.gov.au](http://www.legislation.gov.au).

In addition, APS 221 refers to APRA's *Information Paper – Domestic systemically important banks in Australia* as at December 2013.<sup>2</sup>

## 3. Consultation

In April 2017, APRA commenced a formal consultation on specific proposals with the release of its discussion paper *Revisions to Large Exposures* and a draft revised APS 221.<sup>3</sup> APRA received 13 submissions in response to its consultation from ADIs and industry bodies, and held further discussions with numerous ADIs and industry bodies.

Submissions noted that there would be various challenges to meet the proposed requirements. In particular, a number of respondents noted that the proposed downward revision of prudential limits would cause complications for liquidity management. On requirements relating to measuring and aggregating exposures to counterparties, and disaggregating exposures to the underlying counterparties of structured vehicles, submissions noted that the cost and time required to implement systems to meet these requirements would be substantial and ADIs would require a longer transition period. Modifications to the requirements were

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<sup>1</sup> The Basel large exposures framework can be found at: <https://www.bis.org/press/p140415.htm>

<sup>2</sup> The information paper is available at: <https://www.apra.gov.au/information-papers-released-apra>

<sup>3</sup> The discussion paper is available at: <https://www.apra.gov.au/revisions-large-exposures>

proposed by industry to maintain the need for efficiency whilst balancing concerns regarding financial safety and financial system stability.

In December 2017, APRA released its response to submissions paper clarifying and outlining changes to its proposals in a number of areas following consideration of the issues raised in submissions.<sup>4</sup> The new version of APS 221 incorporates policy changes made following consideration of issues raised and provides industry with a longer transition period on more material enhancements to the large exposures framework. Following the release of the December 2017 version, some further changes were made to requirements on the measurement of large exposures in response to suggestions provided by industry bodies during the development of frequently asked questions.

#### **4. Regulation Impact Statement**

APRA undertook an independent review of revisions to the large exposures framework and have followed a process and analysis equivalent to a Regulatory Impact Statement (RIS). Regulatory costs associated with the revisions to the securitisation framework have been agreed with the Office of Best Practice Regulation.

The document evidencing the independent review has been lodged as supporting material.

#### **5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011**

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

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<sup>4</sup> The response to submissions paper is available at: <https://www.apra.gov.au/revisions-large-exposures>

## ATTACHMENT A

### **Statement of Compatibility with Human Rights**

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

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The legislative instrument is compatible with the human rights and freedoms recognised or declared in the international instrument listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

#### **Overview of the Legislative Instrument**

The purpose of the instrument is to revoke *Prudential Standard APS 221 Large Exposures* determined by APRA in 2014 and replace it with a new *Prudential Standard APS 221 Large Exposures*.

APS 221 sets out requirements for authorised deposit-taking institutions (ADIs) to implement prudent measures to monitor and control their large exposures and risk concentrations, and to set prudent limits on their exposures to counterparties. ADIs are body corporates that have been granted the authority, under the *Banking Act 1959*, to carry on banking business in Australia.

The new APS 221 introduces more conservative prudential limits on exposures to counterparties and stronger requirements for measuring and aggregating exposures. Lower prudential limits are intended to limit large losses to the ADI when a counterparty defaults. Stronger requirements on exposure measurement and aggregation is intended to enhance the ability of ADIs to monitor and control systemic risks which they are exposed to. Broadly, the changes are intended to enhance financial system stability and the financial safety of ADIs to ensure they can meet their financial promises to depositors.

Further minor changes have also been made in the new APS 221 to clarify wording.

#### **Human rights implications**

APRA has assessed the instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instrument is compatible with human rights.

#### **Conclusion**

The instrument is compatible with human rights as it does not raise any human rights issues.