REGULATION IMPACT ANALYSIS OF REVISIONS TO THE LARGE EXPOSURES FRAMEWORK

(OBPR ID: 20968)

Background

APRA's development of its revised prudential framework for large exposures involved an equivalent process and analysis to that required for a Regulation Impact Statement (RIS) as set out in *The Australian Government Guide to Regulation* (the Guide).[1] Through this process, APRA answered the seven RIS questions set out in the Guide, which are summarised below.

Questions 1 and 2 — Assessing the problem and objectives of government action

In its April 2017 discussion paper, *Revisions to Large Exposures*,[2] APRA outlined the problem in relation to APRA's large exposure requirements for authorised deposit-taking institutions (ADIs), as set out in *Prudential Standard APS 221 Large Exposures* (APS 221).These requirements are an important part of the prudential framework and complement other risk management requirements, including risk-based capital requirements. A key purpose of the large exposure requirements is to limit the emergence of large losses in the event of a counterparty failure, and to ensure that ADIs manage risks from concentration and contagion risks. APS 221 was last comprehensively updated in 2003.

During the global financial crisis, and in subsequent years, it became evident that banks have not consistently measured, aggregated and controlled exposures to individual counterparties or to groups of connected counterparties. In particular, the variations amongst jurisdictions regarding measures of exposures and measures of capital and quantitative limits supported the need for the Basel Committee on Banking Supervision (Basel Committee) to review the large exposures framework to facilitate consistent large exposures standards and to ensure banks manage and limit excessive concentration risk.

In April 2014, the Basel Committee released its revised large exposures framework, *Standards: Supervisory framework for measuring and controlling large exposures* (Basel large exposures framework), which replaces the Basel Committee's large exposures guidance on monitoring and controlling large credit exposures released in January 1991.[3] The large exposure requirements complement risk-based capital

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[1] *Australian Government Guide to Regulation*, March 2014

[2] Refer to http://www.apra.gov.au/adi/PrudentialFramework/Pages/Consultation-Large-Exposures-April-2017.aspx.

[3] Refer to https://www.bis.org/publ/bcbs283.htm.

requirements and operate to measure and limit large exposures in relation to a bank's capital. The key aspects of the Basel large exposures framework are:

- a limit of 25 per cent of Tier 1 Capital for an ADI's large exposures to a counterparty or a group of connected counterparties, with national discretion to impose smaller limits for certain types of exposures;
- criteria for identifying a group of connected counterparties; and
- clear and consistent measurement of large exposure values, including specific treatments to be applied for credit risk mitigation, trading book positions, covered bonds, structured vehicles, non-qualifying central counterparties and clearing activities.

The Basel large exposures framework is a recognised international framework. To support access to international markets by Australian ADIs, it is important that the Australian large exposures framework is consistent with the Basel large exposures framework to the extent appropriate.

Failure to implement the Basel standards, including the Basel large exposures framework, may adversely affect Australia's standing globally, given the commitments by the Group of 20 (G20) members to implement Basel standards in a full, timely and consistent manner. Australia's reputation as a member of the Basel Committee, Financial Stability Board and G20, founded on a long-standing commitment to adhere to international standards, could be diminished, limiting Australia's capacity to influence these developments in the future and impacting on the ability of ADIs to access international funding.

APRA proposes to incorporate revisions to the Basel large exposures framework into its ADI prudential framework by updating APS 221, and associated reporting standard *Reporting Standard ARS 221.0 Large Exposures* (ARS 221), with adjustments to reflect Australian conditions.

Questions 3 and 4 — Options to achieve the objectives and impact analysis

As set out in the discussion paper, APRA considered three options in developing proposed revisions to its large exposures framework as set out in APS 221 and associated reporting requirements in ARS 221.

Options	Approach
Option 1: Status quo	Maintain APRA's existing prudential requirements for large exposures
Option 2: Full implementation	Fully implement the Basel large exposures framework with no adjustments

Options	Approach
Option 3: Implementation with adjustments to reflect Australian conditions	Implement the Basel large exposures framework with some adjustments for Australian conditions

Option 1: Status quo

The first option considered was to maintain the status quo where APS 221 and the associated reporting standard are unchanged. Maintaining the status quo would not cause any immediate additional compliance costs for ADIs; however, if APRA's proposals for revisions to the large exposure requirements are not adopted, there are a range of indirect costs and implications that may result, including:

- inconsistencies within Australia and across jurisdictions – variable treatment of large exposures within Australia and across different jurisdictions would result in inconsistent approaches to managing large exposures, there would also be continued uncertainty in the concentration risks affecting ADIs. The lack of transparency in the measurement of large exposures may also misrepresent the riskiness of an ADI to investors resulting in adverse impacts on foreign investor confidence when providing funding to Australian ADIs;

- insufficient protection from large losses – APRA's current large exposure requirements were developed prior to the introduction of certain types of exposures and counterparties that have since grown in prevalence. Significant developments in the financial system in recent years include greater focus on higher quality capital and the introduction of certain assets such as covered bonds. If large exposure requirements do not incorporate the now-recognised need in these areas there could be insufficient protection from large losses; and

- potential for system-wide contagion risk – a key lesson from the global financial crisis has been the potential for material losses in a systemically important bank to compromise the viability of its direct counterparties or connected counterparties. This has flow-on effects to financial stability due to the importance of such entities to the economies they operate in. Current large exposure requirements do not recognise the potential for greater contagion risks from systemically important banks.

Indirect costs are not easily quantifiable. There could be moderate to substantial costs when there is insufficient protection from large losses and contagion risk causes flow-on effects in the economy. The range of implications also depends on the circumstances of an ADI, including the counterparties to which an ADI has exposures, the exposures which an ADI currently recognises and an ADI's methodology for measuring large exposures.

APRA believes the status quo will result in a negative net impact as the costs associated with this option would become more significant at times, such as during a financial crisis, when minimum standards on concentration risk are most needed. Furthermore, if Australia's large exposure requirements are viewed by stakeholders as falling behind international standards, and as incomparable with banks in other jurisdictions, the net impacts of the status quo will be increasingly and significantly negative.

Option 2: Full implementation

This option would fully incorporate the Basel large exposures framework. ADIs would be required to comply with the new requirements by 1 January 2019. This timeframe would allow industry time to make changes to recognise the final revised APS 221 and ARS 221.

Full implementation would address inconsistencies within Australia and between jurisdictions on the measurement of large exposure values, mitigate insufficient protection from large losses and recognise the potential for system-wide contagion risk.

The costs of implementing the Basel large exposures framework would be likely to include:

- some ADIs will need to adjust their exposures to meet revised large exposure limits to ensure excessive concentration risks are identified and appropriately limited. There will be costs associated with identifying counterparties and groups of connected counterparties and assessing and measuring large exposures according to the specified methodologies;

- there would also be increased risk management, compliance and operational costs to meet new requirements, including costs associated with changes to policies, processes, systems and controls to reflect the revised large exposure requirements; and

- there would be an initial increase in costs to amend compliance procedures for changes to reporting requirements and sourcing any additional data required for large exposure reporting forms. However, APRA expects that these costs would be at the margin or minimal as ADIs would most likely be collecting and monitoring such data at present.

Option 3: Implementation with adjustments to reflect Australian conditions

Under this option, APRA would incorporate the Basel large exposures framework in APS 221 and ARS 221 with adjustments to reflect Australian conditions. ADIs would be required to comply with the new requirements by 1 January 2019. This timeframe would allow industry time to make changes to comply with the final revised APS 221 and ARS 221.

APRA anticipates that the compliance costs would be as noted under option 2 above but with differences reflecting the extent to which APRA makes modification to the Basel large exposures framework to reflect Australian conditions.

Under this option, APRA would make targeted adjustments to reflect Australian conditions. These adjustments would provide for a cohesive prudential approach which aligns more closely with APRA's broader prudential framework for supervision of ADIs.

A risk of not making adjustments for Australian conditions is that there are aspects of limits, exclusions from exposures and the measurement of exposures which do not appropriately account for the design of the Australian banking industry and the counterparties of ADIs.

There are broader implications of not adopting this option including the potential for the failure of a counterparty or group of connected counterparties to the extent that large losses impact the solvency of an ADI and leads to repercussions in terms of reputational risk and uncertainty in the banking sector. In the extreme, and particularly where systemically important banks are involved, impacts may be felt throughout the Australian economy, affecting confidence in the economy and of foreign investors who invest in Australia.

Overall, APRA believes this option will have less impact on ADIs compared with option 2 due to the benefits from adjustments specifically tailored to Australian conditions. This option will also mean Australia maintains its reputation for compliance with international standards while enabling a flexible regime so that ADIs are able to remain competitive with international peers and operate in a financial system that is safeguarded from excessive concentration risk.

Questions 5 — Consultation

As noted previously, in April 2017, APRA released a discussion paper for consultation which outlined the three options for the future application and operation of the large exposure requirements noted above. APRA's public consultation was open for three months. Thirteen submissions were received from a range of stakeholders including ADIs, foreign ADIs and industry bodies. APRA has also met with industry bodies and individual ADIs subsequent to the public consultation to further discuss issues raised and refine the proposals. APRA's response to material issues is set out in the Response to submissions paper on APRA's website.

Question 6 — What is the appropriate option

As part of its public consultation, APRA sought information from stakeholders on the compliance impacts of the proposed changes set out in the discussion paper, including associated substantive costs. Respondents were asked to use the Commonwealth Regulatory Burden Measurement tool to assess regulatory costs. None of the submissions provided regulatory cost estimates using this tool; however, some provided high-level cost estimates of the expected cost impacts of implementing the Basel large exposures framework (option 2). APRA has factored these estimates into its own cost estimates for each option and extrapolated the cost impacts for all ADIs on this basis, as well as the estimated impacts of the variations to the Basel large exposures framework to reflect Australian conditions (option 3).

APRA has considered relevant compliance costs (i.e. administration, substantive and financial compliance costs as applicable) in estimating the regulatory cost of each option. This includes the costs of complying with the revised large exposures framework, which primarily relates to systems changes to reflect revisions to the large exposure limits, costs to identify and connect counterparties, update internal policies, procedures and processes and to train staff. APRA has also made assumptions about the nature and extent of cost impacts, including the extent of work involved based on staff numbers and associated staff costs as well as the size of an ADI which will have a bearing on costs. In addition, when estimating the cost impacts, it has been assumed that while ADIs will be directly affected, there are no anticipated direct cost impacts for other stakeholders. All costs represented in the tables in this section reflect the amortised cost per year over a 10-year time horizon.

Option 1—Status quo

Under this option, ADIs and other stakeholders would not incur any additional compliance costs as the current large exposures framework would be retained without change (refer to Table 1 below). However, there would be indirect costs as ADIs would no longer comply with international obligations for large exposures which may affect their ability to participate in international markets.

Table 1—Average annual regulatory costs

Sector	Business	Community organisations	Individuals	Total change in costs
Total change in cost by sector ($ million)	0	0	0	0

Option 2—Full implementation of Basel large exposures framework

Under this option, ADIs would incur additional costs as the existing large exposures framework would be modified to comply with the revised Basel large exposures framework. As noted previously, these costs stem from system costs to reflect the changes to large exposure limits, costs to identify and connect counterparties, update internal policies, procedures and processes and to train staff about the new requirements (refer to Table 2 below).

These costs arise as a result of a number of material changes to the large exposures framework as outlined in the discussion paper. They include changes to the level of capital (from Total Capital to Tier 1 Capital) used in the definition of large exposures, requirements to form a group of connected counterparties and changes to certain large exposure limits and the introduction of new limits, including introducing limits for systemically important banks to recognise the heightened contagion risks and potential for increased financial instability from these exposures. ADIs would also be required to amend systems to report large exposures under the revised framework. This option would apply from 1 January 2019 in line with the Basel large exposures framework.

Table 2—Average annual regulatory costs

Sector	Business	Community organisations	Individuals	Total change in costs
Total change in cost by sector ($ million)	5.81	0	0	5.81

Option 3—Implement the Basel large exposures framework with adjustments to reflect Australian conditions

This option is a variant of option 2 with amendments to reflect Australian conditions and the operation of the Australian ADI industry. This option essentially makes a number of changes based on issues raised in submissions to APRA as part of the consultation process. These changes include:

- allowing ADIs to exclude retail counterparties from the concept of a group of connected counterparties;
- not requiring look-through for structured vehicles which hold retail assets; and
- an extended transition to 1 January 2020 until ADIs are required to look through to the assets of structured vehicles and form groups of connected counterparties consistent with the new requirements.

Table 3—Average annual regulatory costs

Sector	Business	Community organisations	Individuals	Total change in costs
Total change in cost by sector ($ million)	5.45	0	0	5.45

Under option 1, there would be no additional compliance costs. This is because option 1 involves maintaining the existing large exposures framework without change. However, there would be costs to ADIs from not being compliant with the Basel large exposures framework.

Both options 2 and 3 involve compliance costs for industry. Option 3 involves lower costs as APRA would provide a number of concessions to ADIs relative to option 2. APRA considers that option 3 is the better option as it recognises a number of difficulties and complexities in implementing the Basel large exposures framework for ADIs, the costs of which are considered to outweigh any benefits that would arise if option 2 was implemented. In APRA's view, option 3 achieves an appropriate balance between calibrating the large exposures framework that ADIs are required to meet but without significant deviation from the Basel large exposures framework. On this basis, APRA will adopt option 3.

Table 4—Summary of net benefits of each option

	Option 1	Option 2	Option 3
Compliance cost	No change	Moderate cost	Moderate cost
Reduce system-wide contagion and strengthen oversight of large exposures	Does not meet this criteria	Meets this criteria	Meets this criteria
Complies with Basel large exposures framework	Does not meet this criteria	Meets this criteria	Largely meets this criteria
Reflects local conditions	Does not meet this criteria	Does not meet this criteria	Meets this criteria
Overall	**High net cost**	**Moderate net cost**	**Moderate net cost**

Question 7 — Implementation and review

On release of APS 221 and ARS 221, ADIs will have until 1 January 2019 to comply with the revised large exposure requirements and until 1 January 2020 for requirements in relation to groups of connected counterparties and look-through of structured vehicles.

APRA's prudential framework is regularly reviewed, taking into account whether the requirements continue to reflect good practice, remain consistent with international standards and remain relevant and effective in facilitating sound risk management practices.