

## ***Banking (prudential standard) determinations No. 5 of 2023***

### **EXPLANATORY STATEMENT**

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

*Banking Act 1959*, section 11AF

APRA may, in writing, determine, vary or revoke a prudential standard that applies to authorised deposit-taking institutions (ADIs) and authorised non-operating holding companies (authorised NOHCs) under subsection 11AF(1) and (3) of the *Banking Act 1959* (the Act).

On 21 November 2023, APRA made *Banking (prudential standard) determination No. 5 of 2023* (the instrument), which revokes *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180) made under *Banking (prudential standard) determination No. 12 of 2022* and determines a new APS 180.

The instrument commences on 1 January 2024.

#### **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.

APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of institutions. In the case of the banking industry, APRA is empowered under the Act to issue legally binding prudential standards that set out specific prudential requirements with which ADIs must comply.

One of the key components of APRA's prudential framework is the suite of prudential standards which require ADIs to hold regulatory capital as a buffer against the risks which they undertake (capital standards). These capital standards include APS 180.

Counterparty credit risk is the risk that an ADI suffers a loss in the event that a counterparty to a market-related transaction defaults before the final settlement of the transaction's cash flows.

APS 180 sets out requirements for ADIs to adopt risk management practices and hold sufficient regulatory capital for counterparty credit risk exposures arising from over-the-counter derivative transactions, exchange-traded derivative transactions, securities financing transactions and long settlement transactions.

The capital charges for counterparty credit risk include the risk of counterparty default (from both bilateral and centrally clearing parties) and a credit valuation adjustment (CVA).<sup>1</sup> Material to the calculation of capital charges for default risk and CVA risk is

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<sup>1</sup> CVA is the risk of loss due to the deterioration in the creditworthiness of the counterparty to a derivatives transaction. This potential mark-to-market loss is known as CVA risk.

the measurement of the exposure of the underlying transactions in a portfolio. APS 180 implements the standardised approach for counterparty credit risk (SA-CCR) which applies to ADIs who are accredited to use the internal ratings-based approach (IRB) to credit risk under *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113) while other ADIs use a simplified approach – the adjusted current exposure method for measuring counterparty credit risk. Risk weights to counterparty credit risk exposure amounts for regulatory capital purposes are then applied as per APS 180.

## **2. Purpose and operation of the instrument**

The purpose of the instrument is to revoke APS 180 made under *Banking (prudential standard) determination No. 12 of 2022* and replace it with a new version of the prudential standard incorporating minor updates.

As part of a process to ensure minor updates to APRA's prudential framework are made in a timely manner, and part of APRA's strategic initiative to modernise the prudential architecture, APRA is making minor amendments to APS 180.<sup>2</sup> These include a minor consequential amendment to clarify the scope of the standard to exclude non-significant financial institutions (non-SFIs)<sup>3</sup> and a minor amendment to the treatment of eligible CVA hedges (the process through which counterparty credit risk is valued, priced and hedged) in the CVA capital charge calculation.

The key provisions in *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180) are:

- a requirement to calculate counterparty credit risk exposure amounts according to the standardised approach for measuring counterparty credit risk exposures or the adjusted current exposure method and to apply risk weights to counterparty credit risk exposure amounts for regulatory capital purposes;
- a requirement to calculate and hold a CVA risk capital charge;
- a requirement to calculate and hold a capital charge for centrally-cleared transactions;
- a requirement to calculate and hold a default fund capital charge for default fund contributions to a qualifying central counterparty<sup>4</sup>; and
- a requirement to adopt risk management practices for bilateral and centrally cleared counterparty credit risk exposures.

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<sup>2</sup> [Prudential Framework minor updates](#), APRA (Letter, June 2023) and [Modernising the prudential architecture](#), APRA (Information Paper, September 2022).

<sup>3</sup> An ADI (that is not a Foreign ADI) or authorised NOHC that has total assets no more than AUD 20 billion, or determined as such by APRA, having regard to matters such as the complexity in its operations or its membership of a group.

<sup>4</sup> Default funds are clearing members' contributions towards, or underwriting of, a CCP's mutualised loss-sharing arrangements. CCP is a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

APRA may, upon request of an ADI, approve an ADI using the standardised approach to credit risk under *Prudential Standard APS 112 Standardised Approach to Credit Risk* to use the SA-CCR to calculate its counterparty credit risk exposure amount and may require a standardised ADI to use the SA-CCR to calculate its counterparty credit risk exposure amount.

APS 180 also requires an ADI to contact APRA if it wishes to place reliance on a previous exemption or other exercise of discretion by APRA under a previous version of APS 180. This is intended to prevent ADIs from relying on indefinite exemptions or approvals that may no longer be appropriate.

### ***Exercise of discretion by APRA***

APS 180 provides for APRA to exercise various discretions. Decisions made by APRA exercising those discretions are not subject to merits review. This is because these decisions are preliminary decisions that may facilitate or lead to substantive decisions which are subject to merits review.

A breach of a prudential standard is also a breach of the Act, as the Act provides that regulated entities must comply with the standard. However, there are no penalties prescribed for such breaches. Instead, an ADI's breach of a provision in the Act is grounds for APRA to make further, substantive decisions under the Act in relation to the ADI. Those decisions are:

- (a) to revoke an authority to carry on banking business (section 9A of the Act); and
- (b) to issue a direction to the ADI, including a direction to comply with the whole or part of a prudential standard (section 11CA of the Act).

It is only at this stage that an ADI is exposed to a penalty: loss of its authority under section 9A or 50 penalty units if it breaches the direction (section 11CG of the Act). In nearly all cases the decision is preceded by a full consultation with the ADI to raise any concerns it may have in relation to the decision.

A decision of APRA to impose a direction is subject to merits review under section 11CA of the Act, which is appropriately available at the point where an ADI could be exposed to a penalty.

A decision of APRA to revoke an authority under the Act is subject to merits review, unless either:

- (a) APRA has determined that access to natural justice and merits review is contrary to the national interest or contrary to the interests of depositors with the ADI; or
- (b) the authority is an authority that is to cease to have effect on a day specified in the authority (section 9A(8) of the Act).

### ***Adjust and exclude powers***

APS 180 gives APRA the discretion to adjust or exclude a provision of the prudential standard (paragraph 18). The power to create such a discretion is provided for under subsection 11AF(2) of the Act.

APRA may exercise this power when it is satisfied that the adjustment or exclusion of a specific requirement for one or more specified regulated entities will better support APRA in meeting its objectives. For example, the adjustment or exclusion may be necessary to obtain a better prudential outcome than would be the case if the prudential requirement were applied unaltered to a particular regulated entity. A tailored approach would give APRA comfort that the prudential requirements apply appropriately to protect the interests of depositors, policyholders and fund members. APRA will also take into account other considerations, such as efficiency, competition, contestability, competitive neutrality and regulatory burden, including comparisons with an entity's peer group.

The exercise of APRA's powers is governed by a robust decision-making framework which is documented in APRA's internal policies. This framework supports APRA in fulfilling its mandate by limiting decision making to those senior APRA officers with the appropriate experience and skill to exercise prudent judgement. The framework also requires decision makers to seek advice from internal technical experts.

### ***Documents incorporated by reference***

Under paragraph 14(1)(a) of the *Legislation Act 2003* (the Legislation Act), APS 180 incorporates by reference the following documents as in force from time to time:

- Acts of Parliament and associated delegated laws;
- Australian Accounting Standards; and
- Prudential Standards determined by APRA under subsection 11AF(1) of the Act.

All documents incorporated by reference in this standard are available on the Federal Register of Legislation at [www.legislation.gov.au](http://www.legislation.gov.au).

Under paragraph 14(1)(a) of the Legislation Act, APS 180 incorporates by reference the Committee on Payments and Market Infrastructures and International Organization of Securities Commission's *Principles for Financial Market Infrastructures* (CPMI-IOSCO Principles) as it exists from time to time. Under APS 180, the calculation of the capital charge to be applied to exposures to a central counterparty (CCP) is dependent on whether the CCP is treated as a qualifying CCP or a non-qualifying CCP. Whether a CCP is a qualifying CCP involves a question of fact, which is dependent on whether the CCP is subject to rules and regulations that are consistent with the CPMI-IOSCO Principles, rather than an application of the CPMI-IOSCO Principles. The CPMI-IOSCO Principles are not intended to be incorporated into APS 180 and are freely available at [https://www.bis.org/cpmi/info\\_pfmi.htm](https://www.bis.org/cpmi/info_pfmi.htm).

### **3. Consultation**

APRA consulted on the minor updates to APS 180 in June 2023. Five submissions were received on the proposed minor updates and submissions did not object to the APS 180 updates.

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

The Office of Impact Analysis advised that no Regulation Impact Statement was required as the changes to the standards are minor and machinery.

### **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.

## 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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This 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 Instruments**

The purpose of the legislative instrument is to revoke *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180) and replace it with a new version of the prudential standard.

APS 180 sets out requirements for authorised deposit-taking institutions (ADIs) to adopt risk management practices and hold sufficient regulatory capital for counterparty credit risks exposures arising from certain transactions. ADIs are bodies corporate that have been granted the authority, under the *Banking Act 1959*, to carry on banking business in Australia.

### **Human rights implications**

APRA has assessed the legislative 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 legislative instrument is compatible with human rights.

### **Conclusion**

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