

4 October 2018

Ms Heidi Richards  
General Manager  
Australian Prudential Regulation Authority  
Level 12  
1 Martin Place  
SYDNEY NSW 2000

Email [ADIpolicy@apra.gov.au](mailto:ADIpolicy@apra.gov.au)

Dear Ms Richards

## APRA Discussion Paper: Revisions to the related entities framework for ADIs

The Australian Banking Association (**ABA**) appreciates the opportunity to provide comments on APRA's Discussion Paper: *Revisions to the related entities framework for ADIs*, dated July 2018 (**discussion paper**).

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

Our response is structured as follows:

### **Section 1: Key issues and concerns on the proposed revisions to the related entities framework for ADIs:**

- Definition of related entities
- Revised limits on exposures to related entities
- Changes to the extended licenced entity (**ELE**) framework
- Step-in risk and stronger requirements to mitigate reputational contagion

### **Section 2: Feedback on specific proposals in each chapter and an ABA response to questions contained in the discussion paper.**

### **Section 3: Specific comments on the draft Prudential Standard APS 222 Associations with Related Entities.**

### **Section 4: Comments on the draft Reporting Standard ARS 222.0 Exposures to Related Entities.**

## Section 1 - Key issues and concerns on the proposed revisions to the related entities framework for ADIs

- **Definition of related entities** – APRA’s proposed expansion of the definition to include associates, individuals, substantial shareholders and other entities that may expose the ADI to step-in risk is a significant change to the regime’s scope. The ABA is concerned this will create a considerable and unnecessary burden on ADIs to identify and report these exposures, with minimal prudential benefit. This broad definition is more appropriate for a small ADI with significant control and influence from a few entities and/or individuals and is not applicable to the majority of ADIs operating in Australia.
- **Revised limits on exposures to related entities** – Given the number of other reforms to the capital framework both domestically and offshore (including the New Zealand Reserve Bank review of the capital adequacy framework for registered banks<sup>1</sup>) the ABA would strongly argue these revisions are not just overly conservative but also potentially unnecessary given the significant number of interlinked prudential reforms underway. The ABA would strongly recommend a deferral of reforms to APS 222 until the other revisions (both domestic and overseas) to the capital frameworks are finalised. Only when the regulatory landscape has clarity should APRA revisit changes to APS 222.

### ADI equivalent limit of 25 per cent

The proposed reduction in exposure limits to 25 per cent of Level 1 Tier 1 Capital for ADI equivalent subsidiaries is overly conservative as it is aligned to the same exposure limit that applies to large external bank counterparties. ABA believes that the proposal doesn’t recognise the benefits of:

- Being a subsidiary, the parent ADI has greater access to information and influence than exists with an external counterparty; and
- That a subsidiary exposure has greater Level 1 capital allocated to the exposure than an external bank exposure due to the inherent structural differences between related and unrelated exposures.

The ABA recommends a maximum 40 per cent limit be applied to all ADI equivalent subsidiaries with an appropriate scale up to 120 per cent of Level 1 Tier 1 Capital for the aggregate exposure limit.

- **Changes to the ELE framework** – The ABA is surprised at APRA’s proposals, which would exclude a number of subsidiaries from ADIs’ ELEs. We do not believe that the ELE framework was introduced solely for efficiency of reporting and has been a framework widely used by the industry. The ABA recommends that APRA should keep the existing ELE framework and provide further guidance to ADIs on APRA’s expectations around asset transferability, further detail on the ABA recommendation is included in our response to Chapter 4.
- **Step-in risk and stronger requirements to mitigate reputational contagion** – Introducing step-in risk as a prudential item is a significant change which requires separate consultation given the potential breadth of exposure and implications. The ABA requests that this is dealt with separately to the related entity framework. Similarly, we are concerned that reputational risk is undefined, creating the potential for inconsistent interpretations and application across the industry. The ABA requests further clarity on this term and how it could be measured by ADIs and welcomes a separate consultation on these topics.

<sup>1</sup> Reserve Bank of New Zealand, Review of the capital adequacy framework for registered banks, 06 July 2018

## Section 2 - Feedback on specific proposals

### Chapter 2 – Scope and risk monitoring

#### 2.1 Definition of a related entity

APRA proposes to closely align the definition of a related entity with the definition contained in the Basel Committee's Core principles for effective banking supervision. APRA's view is that the proposed definition, set out in Table 1 – *Current and proposed definition of an ADI's related entities*, will enhance the ability of ADIs to identify entities which expose the ADI to contagion risk or conflicts of interest and bring these entities into the scope of APS 222's requirements.

The new definition incorporates Corporations Act definitions which are too broad. In particular:

- (1) the associate definition employed extends the control test to qualifying investments and whether such investments are material to either the ADI or the associate. This is more suitable for other contexts such as assessing auditor independence and unsuited for this purpose. It would be a significant burden on ADIs to capture and report these exposures;
- (2) the expansion to substantial shareholders and their associates puts ADIs at risk of inadvertently breaching related party exposure limits, in a way that is out of their control, if a new substantial shareholder with numerous associates (e.g. a large global fund manager) comes on the register. This will cause unintended consequences for listed ADIs who do not have control over the behaviour of market participants and investors; and
- (3) there are circumstances where an ADI could be deemed to control an entity for the purpose of paragraph 8(d) of the draft APS 222, however may not have access to information regarding, or otherwise be able to identify, all of the "associates" of that entity.

The ABA would hold that a more appropriate definition would be limited to:

- (1) an entity which is directly or indirectly controlled by the ADI; and
- (2) an entity which directly or indirectly controls the ADI.

Reasons to support the above arguments are as follows:

#### **Substantial shareholder**

The new definition requires ADIs to treat a substantial shareholder, and the substantial shareholder's associates, as a related entity. The ABA would argue that the definition is too broad. The listed ADIs are widely held, with registered shareholdings often grouped under large custodians, nominees and professional asset managers. Additionally, the ABA acknowledges APRA's confirmation on page 13 of the discussion paper that it "does not intend for ADIs to treat custodian banks as related entities where the role of the custodian bank involves an arrangement to hold shares in an ADI on behalf of external counter-parties, and the custodian bank does not exercise control over individual voting rights". With this in mind, the process of tracking the beneficial owners of shares owned by custodians is often complex as data on the beneficial owners may not be readily available. It would cause unintended consequences if ADIs are required to monitor and report exposures to these entities and their associates.

If the proposed treatment of substantial shareholders remains unchanged in the definition, the ABA requests that exceptions to this requirement are provided to minimise unintended consequences, such that entities such as custodians, nominees and professional asset managers (which are acting on instructions of multiple underlying clients) are excluded.

#### **Individuals and their relatives and associates**

The proposed definition of related entity includes a related individual of the ADI and the related individual's relatives, and their associates.

On this aspect, the ABA would welcome APRA's guidance on how the proposed APS 222 is intended to operate alongside Australian privacy regimes and consumer credit laws. Senior management and directors of ADIs operating in Australia do not have or exert sole control or influence over the affairs of the ADI to warrant inclusion in the definition of related entity. The ABA does not consider that these individuals should they be caught by APS 222. APRA has not explained why the affairs of these individuals should be included in the prudential framework. Such a broad reaching definition is fraught with legal and operational issues making it potentially unworkable.

### **Entities which expose the ADI to step-in risk**

Introducing step-in risk as a prudential requirement is a significant change which warrants a separate consultation given the potential breadth of exposure and implications. The ABA requests that this be removed from the definition of related entity and is dealt with separately to the related entity framework.

The ABA is unclear how APS 222 definitions will operate alongside the definitions included in *Prudential Standard APS 001 – Definitions* and the Corporations Act, particularly where there are differences in the text. For example, the related party definition in APS 001 is different to that contained in APS 222, along with a different definition for "control" when compared with the Corporations Act. The ABA would welcome clarification whether the definitions in APS 222 will over-ride APS 001. Equally the ABA seeks to understand whether the APS 222 definition will cross over to applications into other standards i.e. APS 221 or APS 111. The ABA recommends that definitions are those set out in APS 001 to eliminate confusion across all standards.

## 2.2 Assessing contagion risks from group structures and related entities

No issues identified.

## 2.3 Policies on dealings with related entities

Please see ABA comments under Section 3: *Specific comments on the draft Prudential Standard APS 222 Associations with Related Entities*, in particular our comments regarding paragraph 19 of the draft APS 222.

## 2.4 Provision of support

The ABA would welcome further APRA clarification of the capital treatment of arm's length agreements. The ABA seeks to understand what is meant by the term 'capital support'. Currently, transacting arm's length not captured.

The ABA would also welcome confirmation that letters of comfort will be not be included within the regime as such letters are not considered a guarantee and does not place an obligation on the bank to step-in. The ABA would also highlight for APRA that ADIs may currently have a subset of current capital support in place today which is not fixed as to time, given the perpetual nature of a common equity investment. The ABA would welcome further APRA guidance on this matter.

### Residual value subsidiary arrangements

We welcome APRA's clarification that residual value subsidiary arrangements are not captured under this provision, given they are already accounted for under the market risk framework.

## 2.5 Step-in risk

Given the following (current and proposed) APRA requirements, namely:

- the requirement for an ADI to deal with related entities, funds management SPVs and securitisation SPVs on an arm's length basis and on market terms and conditions (clearly, supporting an entity beyond any legal obligation to do so is not arm's length nor on market terms and conditions)<sup>2</sup>;

<sup>2</sup> Paragraph 11(a), draft APS 222; paragraph 13, APS 120 (May 2006); paragraph 13, APS 120 - Securitisation

- the requirement for an ADI to address risks arising from dealings with related entities as strictly as it would address its risk exposures to unrelated entities<sup>3</sup> (supporting an entity beyond any legal obligation is not consistent with the standard to which an ADI would address risks arising from dealing with unrelated entities);
- the prohibition against an ADI having unlimited exposures to related entities (a risk that an ADI will step-in and support another entity beyond any legal obligation to do so is, by definition, unlimited)<sup>4</sup>; and
- the requirement to adhere to limits to related entities (see prior point)<sup>5</sup>.

The ABA would hold that the inclusion of the step-in risk concept in the related entity definition is not warranted. Effectively, these requirements amount to a collective rebuttal of step-in risk in relation to related entities and securitisation vehicles. Therefore, the inclusion of step-in risk in the definition of 'related entity' would be contradictory to these other requirements and unnecessary.

## Chapter 3 – Exposures and limits

There are a number of other significant capital reforms underway both domestically and offshore (including the New Zealand Reserve Bank review of the capital adequacy framework for registered banks<sup>6</sup>), the ABA would argue the revisions APS 222 are not just overly conservative but also unnecessary given the number of interlinked prudential reforms in progress. The ABA would recommend a deferral of these reforms to APS 222 until the other revisions to the capital framework are finalised.

### 3.1 Limits on exposures to related ADIs

#### 3.1.1 Exposure to individual related ADI

The ABA would not support the limits proposed by APRA. Cutting limits by 50 per cent is an excessively punitive treatment particularly where the only rationale provided for such calibration is consistency, the ABA would argue the cost would exceed the benefit.

#### 3.1.2 Aggregate exposure to all related ADIs

As above 3.1.1.

### 3.2 Limits on exposures to other related entities

The ABA questions the proposed limit such that an exposure to an individual unregulated related entity and aggregate limit for exposures to other related entities would also apply to exposures to related individuals and substantial shareholders that are not related ADIs.

The rationale for applying the same limit for both external counterparty and related entity does not seem to be risk based and fails to take into account that an ADI has control over a related entity but not an external counterparty.

### 3.3 Measurement of exposures to related entities

Under the revised APS 221, requirements relating to the measurement of large exposures were amended. APRA proposes to adopt the same requirements on measuring exposures to related entities to ensure consistency.

The ABA would not support the limits proposed by APRA.

<sup>3</sup> Paragraph 8(a), APS 222

<sup>4</sup> Paragraph 10(a), APS 222; paragraph 13(a), draft APS 222

<sup>5</sup> Paragraphs 26 and 27, APS 222; paragraphs 29 and 33 – 36, draft APS 222

<sup>6</sup> Reserve Bank of New Zealand, Review of the capital adequacy framework for registered banks, 06 July 2018

### Look-through

Where an ADI is required to comply with paragraph 35 of the draft APS 222 the exposure is recorded against the structured vehicle and the underlying asset(s). To avoid double counting the exposure for the purposes of paragraph 29 (b)(iii) it should be made explicit that only the exposure to the structured vehicle is required to be captured for the purposes of this calculation, where the exposure has also been assigned to the underlying asset(s). Furthermore, an ADI will recognise the exposure to the underlying asset under APS 221, hence the ABA requests further clarity if it is APRA's intention to recognise it as an exposure under APS 221 which is focussed on managing concentrations to unrelated entities.

## ABA response to Chapter 3 consultation questions

### *Q 3.1 What are the potential impacts of the proposed prudential limits and revisions to the measurement of exposures?*

In addition to our comments above, a decrease in limits would also further restrict an ADI's ability to support related entities during periods of stress. In some instances, this may increase contagion risk which would have ordinarily been avoided by an appropriate level of support. The ABA is of the view that limiting exposure to 25 per cent of Total Capital provides a suitable balance between reducing the risk of contagion while ensuring related entities are supported accordingly.

## Chapter 4 –The extended licensed entity (ELE) framework

### 4.1 Current ELE arrangements

The ABA is surprised at APRA's proposals, which would exclude a number of subsidiaries from ADIs' ELEs. We do not believe that the ELE framework was introduced solely for efficiency of reporting.

A domestic holding company holding shares in an overseas subsidiary poses no new or different risks to the assets of that holding company being available to depositors than if the ADI held the shares in the offshore subsidiary directly, thus the ABA does not think the domestic holding company should be excluded from the ELE. The ABA disagrees with APRA's argument that the treatment is justified because the overseas business may not be remitted back to the ADI. This argument confuses the fact that the holding company owns the shares in the overseas business and not the actual assets in the business operated by the overseas subsidiary. The holding company is subject to the laws of the Australian jurisdiction and not overseas laws, therefore overseas insolvency proceedings are not a relevant consideration when considering whether the assets of the domestic holding company are available to Australian depositors of the ADI.

### 4.2 Proposed revisions to the ELE framework

APRA has not evidenced or provided practical examples of difficulties in transferring funds or assets out of overseas ELE subsidiaries. The ABA would argue that APRA's proposed reforms to the ELE framework will have a significant and disproportionate impact on the ability of ADIs to conduct and grow overseas business activities (which in turn allows ADIs to diversify risks and revenue streams), to address the more abstract and remote risks identified in Chapter 4 of the discussion paper.

The complexity argument put forward by APRA in support for simplification does not consider the benefits from having more entities in the event of an executed recovery (in the event of bail-in). Operating businesses through subsidiary entities enables an ADI, in a recovery scenario, to execute recovery actions by selling the entities, rather than having to sell specific assets, contracts etc, where a recovery action is the disposal (or spin-out) of a business line. This argument for simplification by reducing numbers of entities is therefore not supported by the ABA. A better solution to address perceived complexity of supervision could be through more granular reporting to APRA, and as is always the case, APRA could request further information.

The ABA recommends that APRA should keep the existing ELE framework, and if required provide further guidance to ADIs on APRA's expectations around asset transferability. As a first step the ABA would welcome further detail surrounding APRA views of the apparent difficulties faced by ADIs in repatriating assets and funds from overseas, the ABA is not aware of any ADI or systemic difficulties during the period of the ELE regime.

Following the above approach, once the ABA understands APRA's concerns with the current framework, one option for consideration may be to permit a continuation of the ELE framework in countries that are 'safe' – for example, countries that under an ADI's country risk framework are considered to have low political and regulatory risk – and imposing a separate limit (potentially using the UK non-core large exposures group concept as a starting point for designing the limit) on other jurisdictions. Changes to the ELE framework, such as above would need a number of grandfathering and transitional arrangements of a significant duration and the ABA would welcome an opportunity to engage with APRA on that work.

The ABA notes that following the finalisation of the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 (**Crisis Management Act**), and APRA's ongoing work on recovery planning at ADIs, APRA expects to undertake further work on resolution matters as they relate to offshore operations of ADIs. The ABA also notes APRA's expressed opinion in the discussion paper that overseas branches of ADIs pose similar risks, and queries whether APRA intends to make further changes to the related entities framework. The ABA would encourage APRA to take a holistic approach to these reforms as the regulatory cost of these changes is significant and resources are limited given the amount of reforms underway.

#### ABA response to Chapter 4 consultation questions

**Q 4.1** *What is the potential commercial impact to removing the ELE-eligibility of overseas subsidiaries which are established to hold or invest in assets?*

There are a number of commercial impacts in removing the ELE-eligibility of overseas subsidiaries, these include a reduction in the ability of ADIs to carry on overseas activities. The proposed limits on exposures to subsidiaries could result in more costly and less certain funding and possibly generate the need to find third party financiers to fund activities if the ADI cannot. The setting up of overseas subsidiaries is a costly exercise and also has limits. The growth in the number of overseas branches may be limited in the future under APRA's proposed policy setting; which in turn will lead to:

- a reduction in diversification of assets and risks, reduction in (diversified) income streams; leads to;
- a more concentrated, narrow and domestic-focused banking sector; *and*
- less assets available to Australian depositors (the depositor preference regime means that assets in overseas ELE subsidiaries will be available to the Australian parent and therefore, *in preference*, to Australian depositors, especially in a crisis scenario, *unless* something disrupts transferability – which the ABA considers a remote risk that APRA needs to further substantiate to justify such significant reforms.

The ABA view is that removing the ELE-eligibility of overseas subsidiaries ultimately adds more risk to the system and APRA has not adequately evidenced the need for this proposed change. The ABA recommends that APRA should keep the existing ELE framework and provide further guidance to ADIs on APRA's expectations around asset transferability.

**Q 4.2** *What transition period would be required to mitigate the impacts of the proposals in this paper?*

As per the ABA recommendation under 4.2 Proposed revisions to the ELE framework.

*Q 4.3 What additional or alternative measures could be taken to mitigate the risks and concerns expressed regarding offshore ELE subsidiaries?*

As per the ABA recommendation under 4.2 Proposed revisions to the ELE framework. The ABA has recommended additional reporting by ADIs to APRA, plus possibly reducing the number of 'levels' below the ADI which are eligible for inclusion in the ELE, to aid ease of supervision.

## Chapter 5 - Group badging and other matters

### 5.1 Group badging

In regard to paragraph 23 of the draft APS 222, the ABA would welcome more clarity as to exactly what represents a sale of a financial product. For example, does it include financial planning services, share trading etc.

### 5.2 Disclosures

APRA proposes to require ADIs to ensure that external counterparties to a financial transaction with a group member provide an acknowledgement to indicate that they have read and understood the disclosures. This aligns with disclosure and acknowledgement practices that funds management entities apply consistent with Prudential Standard APS 120 Funds Management and Securitisation (2006).

The ABA considers the above proposal an unnecessary overreach given the sophistication of the parties (corporates) and due diligence already undertaken. The ABA does not think the APRA proposal is necessary and queries how it would improve the status quo.

Further, the ABA would hold that APRA has not sufficiently argued the case that explicit acknowledgments, especially for wholesale counterparties, will improve understanding by counterparties of the identity of the entity they are dealing with.

### 5.3 Participation in group-wide operations

Regarding paragraph 28 of the draft APS 222, the ABA would suggest that Board approval is only required where the ADI's participation is material – we acknowledge that this is an existing requirement, however the inclusion of materiality test would be a welcome addition as ADIs implement the intent and purpose of these reforms in the most efficient way.

## ABA response to Chapter 5 consultation questions

*Q 5.1 How effective are current requirements relating to group badging and disclosures on mitigating the potential for reputational contagion to flow to the ADI?*

The ABA considers current requirements are sufficient, well understood and embedded within the disclosure processes of ADIs. Imposing an obligation to obtain counterparty or customer acknowledgment of disclosures in application forms and other financial transaction documentation would require significant investment in systems, forms, stationery and risk controls. The ABA does believe that this measure would materially reduce the potential or likelihood of reputational contagion risk for an ADI versus the current clear, comprehensive and prominent disclosure regime.

*Q 5.2 Are acknowledgements of disclosures effective in ensuring information is understood? Can these be implemented via electronic means?*

Existing 'clear, comprehensive and prominent' disclosures in current terms and conditions are sufficient to inform customers of the roles and responsibilities of the separate legal entities. It is unclear on what basis APRA believes that a direct acknowledgment is necessary within Prudential Standards. The ABA does not believe that this proposed measure would materially reduce the potential or likelihood of reputational contagion risk for an ADI.



*Q 5.3 What alternative measures could be taken to enhance requirements on group badging and disclosures to mitigate reputational impacts to the ADI?*

An alternative measure to enhance group badging is to maintain the existing carve-out of regulated entities and to otherwise require clear and prominent disclosure on relevant Group internet sites which promote the relevant products or through which the product may be acquired (without the need for a specific declaration/acknowledgment).

## Chapter 6 - Notification and approval requirements

The ABA considers the prior notification requirements in paragraph 37 effectively being more than just a notification obligation and more akin to a prior consultation requirement or an approval power due to the APRA's ability (as per paragraph 38) to require an ADI not to proceed with a proposed transaction.

It cannot be a simple notification if such a notification by an ADI triggers a review process of unspecified duration within APRA. The ABA would hold that the text in the draft APS 222 should be modified to reflect the nature of the process and that timeframes for responses from APRA should be express in the standard.

## Chapter 7 - Funds management activities

### 7.1 Scope and definition of funds management

APRA proposes to keep the definition of funds management from APS 120 (2006), that is, funds management is the provision of investment and related services for the management of investors' funds. APRA also proposes that the requirements relating to funds management activities in Attachment B of the proposed APS 222 apply to an ADI's associations with a funds management vehicle that is treated as a related entity of the ADI. The ABA is concerned about possible duplication across APS 120 and the new APS 222. Does APRA intend to abolish APS120 and rely on APS 222; or amend APS 120 to ensure consistency?

### 7.2 Separation and disclosure

See 7.1

### 7.3 Purchase of securities, and underwriting

One concern with APRA's proposal is that the forced disposal of securities within two months runs counter to good risk management as it effectively triggers a 'fire sale' requirement for any shortfall. The ABA recommends the time restriction on the obligation is removed and replaced with an obligation to complete the disposal as soon as practicable.

### 7.4 Provision of liquidity facilities

See 7.1

## Chapter 8 Reporting of exposures to related entities

The ABA again highlights the ongoing mismatch of reporting dates will mean reporting within 28 days will not be possible. The reporting date is 28 calendar days from period closed, however, ADIs are currently reporting capital 30 days from the period closed. Capital derived from the Level 1 ARF 110 report is used as the denominator for calculating the percentage exposure for ARF 222 return.

## ABA response to Chapter 8 Consultation questions

*Q 8.1 Are there any operational difficulties to reporting substantial shareholders and changes in substantial holdings, and the twenty largest exposures to related entities, under proposed changes to ARS 222.0?*

Yes, there is a mismatch of reporting dates between ARF 222, and ARF 110 (28 calendar days vs 30 business days (advanced banks) or 20 business days (standardised banks)). The ABA continues to recommend that ARF 222 maintains 30 business days as capital derived from the Level 1 ARF 110 is used as the denominator for calculating the percentage exposure for ARF 222 return.

## Chapter 9 Consultation and next steps

Given the number of other reforms to the capital framework both offshore (including the New Zealand Reserve Bank review of the capital adequacy framework for registered banks<sup>7</sup>) and domestically the ABA would strongly argue these revisions are not just overly conservative but also potentially unnecessary given the significant number of interlinked prudential reforms underway. The ABA would strongly recommend a deferral of these reforms to APS 222 until the other revisions (both domestic and overseas) to the capital frameworks are finalised. Only when the regulatory landscape has clarity should APRA revisit changes to APS 222.

## ABA response to Chapter 9 Consultation questions

*Q 9.1 What proposals will require a transition period beyond the proposed commencement date of 1 January 2020?*

Noting another ABA recommendation that APRA should keep the existing ELE framework, and if required APRA to provide further guidance to ADIs on their expectations around asset transferability. Should APRA implement any reforms to the ELE framework, changes would need a number of grandfathering and transitional arrangements of a significant duration and the ABA would welcome an opportunity to engage with APRA on that work.

In regard to the reporting changes, the ABA would suggest that an implementation period of two years from release of a final reporting standard given the significant number of other reporting reforms currently underway.

---

<sup>7</sup> Reserve Bank of New Zealand, Review of the capital adequacy framework for registered banks, 06 July 2018

## Section 3: Specific comments on the draft Prudential Standard APS 222 Associations with Related Entities

### Minor drafting queries

There looks to be cross-referencing drafting errors in paragraphs 17, 40 and 43. Should the reference to related entities in paragraph 43 (b) be to unrelated entities?

### Paragraph 12

APRA should consider the inclusion of a materiality threshold in paragraph 12, otherwise the current drafting will result in immaterial matters being elevated to the board. There is also a potential operational issue if minor commercial matters need to be dealt with some urgency by an ADI and the next board meeting is not imminent.

### Paragraph 19

The ABA would welcome further guidance and clarification of paragraph 19. For example, if an ADI is purchasing assets from a subsidiary is the deduction for the amount of the capital relief that the subsidiary receives i.e. the face value at risk weight at capital ratio, or is the deduction the face value of the purchase? If it is the latter, the ABA seeks to understand the logic behind why that would be the case? Further, if the capital relief is received, what is the treatment for the balance of the face/transaction amount? The ABA seeks to understand would this now be classified as an APS 222 exposure? The ABA would argue against that view as the ADI has bought the asset.

The ABA is concerned that the current drafting of paragraph 19 could be interpreted to mean that any purchase from a subsidiary is capital support or an APS 222 exposure.

Paragraph 19 does not clearly address the question of how long does an asset purchase remain an active APS 222 or APS 111 issue? Is it the life of the asset, or does APRA intend there to be a sunset clause on the exposure as to capital deduction or APS 222?

The ABA notes that paragraph 19 refers to “or other liabilities” of the ADI as being covered. The ABA would welcome further guidance on this as we seek to understand how a liability could be classed as an exposure for the ADI.

### Paragraph 29 - Limits on exposures to related entities

The draft standard proposes to set a 25 per cent of Level 1 Tier 1 Capital for ADI equivalent subsidiaries. This would be aligned to GSIB exposure limit under APS 221. The ABA believes that a higher limit is appropriate for the following reasons:

- As a controlled entity, the ADI has greater access to information regarding financial performance and the ability to influence the decision-making process of the subsidiary than an external bank counterpart. This will enable the ADI parent to manage and mitigate the potential for financial loss and hence this should be reflected in a higher exposure limit.
- Exposure levels to ADI equivalent subsidiaries will generally be higher than for an external bank counterpart due to the inclusion of equity exposures whereas external banks exposures will be limited to senior on and off-balance sheet exposures.
- We note that APRA capital standards preference parent ADIs funding ADI equivalent subsidiaries with internal AT1 and Tier 2 Capital securities rather than having the subsidiary access the external market. These regulations include Level 2 Minority Interest hair-cuts that increase the effective cost to the ADI group; compliance with both APRA and the overseas regulator’s capital standards, dual non-viability triggers on the ADI parent and subsidiary, and the administrative issues associated with the AT1 securities converting into parent ADI ordinary shares.

- Capital levels to ADI equivalent subsidiaries are likely to increase in the future as local regulators increase local capital requirements, as the remaining items of sections of the BCBS reform agenda are implemented. This includes the introduction of TLAC, coupled with the potential for a single-entry point for recovery and resolution frameworks which will require the parent ADI to raise capital and down-stream it to ADI equivalent subsidiaries.
- The inclusion of capital securities within the ADI equivalent exposure of the subsidiary results in higher amounts of Level 1 capital being held against that exposure than external bank exposures. This results in a lower unfunded residual capital exposure should the ADI equivalent subsidiary fail when compared to the external bank counterpart. ABA modelling (see Annexure 1 - Benchmark of banking subsidiary's limit) based on capital exposures risk weighted at 400 per cent; senior external bank exposure risk weighted at 30 per cent (conservative for a GSIB); and a CET1 capital target of 10.5 per cent indicates that the 25 per cent limit to an external bank counterparty (APS 221) would equate to a ~40 per cent ADI equivalent subsidiary to align the unfunded residual CET1 capital exposures at Level 1.
- The limit set in paragraph 29 is a maximum limit and the ADI parent must still set an operational limit for each ADI equivalent subsidiary based upon its risk assessment of the subsidiary and the impact on the ADI's stand-alone capital and liquidity positions in the event of the subsidiary failing (refer paragraph 11(b)). This requirement acts as a safety net to the ADI merely setting the maximum exposure for all subsidiaries.

The ABA recommends that APRA sets the "ADI or overseas based equivalent" maximum limit under paragraph 29(a) at 40 per cent of Level 1 Tier 1 Capital for individual exposures, with an appropriate scale up to 120 per cent for the aggregate exposure limit. This would recognise the ADI parent has greater access to information and ability to influence a subsidiary, and the inherent structural differences between the exposures to ADI equivalent subsidiaries and external bank counterparties.

### Paragraph 31

Paragraph 31 requires an ADI's exposures to a foreign parent to be within the APS 221 prudential limits or 25 per cent of Tier 1 Capital. This requirement was unexpected since the consultation on APS 221 stated "*Prudential limits and other requirements for an ADI's exposures to other related entities are contained in Prudential Standard APS 222 Associations with Related Entities*" and note 6 in the final APS 221 reiterates the above policy position. APS 221 states "*Prudential limits on an ADI's exposures to related entities are set out in Prudential Standard APS 222 Associations with Related Entities*". Paragraph 31 is worded very broadly and should be further clarified as it is not clear whether "foreign parent" refers to the immediate operating foreign parent or to the ultimate parent.

The ABA recommendation would be to remove paragraph 31 altogether or alternatively allow a higher limit of minimum 50 per cent of Tier 1 Capital as the limit proposed by APRA is substantially more restrictive than prudential limits proposed under paragraph 29 which applies to local ADIs without foreign parents. Higher limit on exposures to foreign ADI parent and its overseas based subsidiaries are further supported by parental holding of all capital debt instruments that should mitigate contagion risk. In addition, some scope should be allowed for local subsidiaries of foreign ADIs to seek higher limits considering individual circumstances, the foreign parent financial soundness and their prudential framework.

The ABA encourage APRA to consider the economic and competitive implications of stricter limits on local subsidiaries of foreign ADIs including undermining their capacity in trade financing, cross border credit providers and impeding efficient risk management practices. In regard to these stringent limits, the ABA supports an implementation timeframe no earlier than 2021 and a preference that coincides with APRA's revisions to the capital framework.

## Section 4: Comments on the draft Reporting Standard ARS 222.0 Exposures to Related Entities

Item 8 in Memorandum Items on page 4 of the draft ARF 222.0: Exposures to related entities, requires ADIs to disclose the aggregate exposure to all related entities. The ABA has a concern regarding this given the expanded definition of a related entity.

### Memorandum items

6. Tier 1 Capital

7. Aggregate exposure to all related ADIs (including overseas based equivalents)

8. Aggregate exposure to all related entities (other than related ADIs and related overseas based equivalents)

8.1 of which: to non-regulated related entities

The draft reporting standard will require ADIs to have systems to capture all balances irrespective of materiality to related entities that have been additionally included under the new definition (these are related entities other than controlled entities).

Under a strict reading of the draft standard and reporting form, ADIs will need to have systems to capture immaterial balances such as credit card balances, personal loans of individuals classified as related parties under the new definition (e.g. group executives, directors, and other senior management and their dependents) to meet APRA's requirement.

The ABA recommends that APRA specify a limit (e.g. above \$100m) for exposures to related entities other than to controlled entities to ensure immaterial exposures are kept out of scope. Through requiring immaterial balances of exposures for related parties to be reported on, APRA will be departing from the stated objectives of the discussion paper, i.e. to mitigate the flow of contagion risk to ADIs. We recommend consideration of a reasonably substantial exposure threshold for reporting purposes.

### Conclusion

The ABA is cognisant of the size and complexity of the task APRA has in finalising and calibrating a number of significant reforms to the Australian prudential framework. The ABA looks forward to continued dialogue to ensure an appropriate implementation of the capital framework for Australian ADIs.

Thank you again for the opportunity to respond to the proposals.

Yours sincerely

*Signed by*

Aidan O'Shaughnessy  
Executive Director, Policy  
02 8298 0408  
aidan.oshaughnessy@ausbanking.org.au

## Annexure 1 – Benchmark of banking subsidiary’s limit

The model below sets out that a 25 per cent limit to an external bank should align to a 39 per cent limit for an ADI equivalent subsidiary such that the value of unfunded capital on the exposure is equalised.

Annexure 1- Benchmark of limit for banking subsidiaries					
Level 1 Capital	Notes	External 1,000	Internal 1,000	Proforma 1,000	
Limit	1	25%	25%	39%	156%
Volume		250	250	390	
Debt %	2,3	100%	20%	13%	
Equity %	4	0%	80%	87%	
Debt Volume		250	50	50	
Equity Volume		-	200	340	
		250	250	390	156%
Debt RW	5,6	30%	100%	100%	
Equity RW	7	400%	400%	400%	
Debt RWA		75	50	50	
Equity RWA		-	800	1,360	
		75	850	1,410	
CET1 target	8	10.5%	10.5%	10.5%	
CET1 Capital		8	89	148	
Unfunded CET1	9	242	161	242	0
CET1 Capital		3.2%	35.7%	38.0%	
Unfunded CET1		96.9%	64.3%	62.0%	
Unfunded	9	24%	16%	24%	
<b>Notes:</b>					
1. APS221 limit is 25% for external banks; Proforma is the limit that equalises the unfunded capital value					
2. APS221 limit used to fund 100% debt as capital securities are a capital deduction					
3. Debt for subsidiary is assumed to be 20% usage of limit - consistent with APRA Trans-Tasman rule that applied a 5% Tier-1 sub-limit					
4. Equity for subsidiary assumed to be 80% as will be the majority of the exposure					
5. Debt RW for external counterparty assumed to be 30% given would be a bank with a very high credit rating					
6. Debt RW for subsidiary is the standardised rate					
7. Equity RW is as per APS111 Attachment D Paragraph 8					
8. CET1 target set at CET1 unquestionably strong 10.5%					
9. Is the unfunded CET1 capital at Level 1 for the maximum exposure limit					

In the above example, a 25 per cent APS 221 limit to an external bank creates a \$250 limit against which the ADI fund/allocate \$8 of Level 1 CET1 capital for the RWA, and hence if the external bank fails completely, the ADI has to find \$242 of CET1 capital to absorb the loss. A 25 per cent APS 222 limit to an ADI equivalent subsidiary requires \$89 of CET1 capital to be funded now and hence the ADI has an unfunded CET1 capital position of \$161 if the subsidiary fails. To align the ADI’s unfunded Level 1 CET1 capital position to the external bank counterparty exposure i.e. \$242, the ADI equivalent subsidiary APS 222 limit would be ~39 per cent.