24 February 2020

Mr Michael Murphy
Senior Manager,
Cross-industry insights and data division
The Australian Prudential Regulatory Authority
By email DataAnalytics@apra.gov.au

Dear Mr Murphy

ARS 115 Standardised measurement approach to operational risk

The ABA submission to the ARS 115 consultation below asks APRA to consider the ARS 115 consistency with the accounting standard: and consistency with current data consultation outcomes. In particular, the current APRA consultations on quarterly data reporting and data confidentiality.

Further, the ABA asks APRA to consider a more flexible implementation date for some ADIs. The complexity of some banks and the need for clarification of a number of issues mean some banks will need greater implementation time than provided by the 1 January 2021 due date.

The remainder of the ABA submission provides specific industry feedback on:

- Clarification of financial statements and dates
- Frequency of data updates
- Prior period reporting
- Due date for submission of the quarterly return
- Treatment of operational risk losses
- Data confidentiality
- Treatment of dividend income
- Prior period information for mergers and acquisitions

We thank you for taking our comments into consideration, and we look forward to future discussions on operational risk.

Yours faithfully

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1. Introduction

The ABA submission has both overarching comments on the approach to the reporting standard and specific feedback.

In terms of overarching feedback, the ABA would like APRA to review the consistency of the final ARS 115 with generally accepted accounting principles. There are a number of instances where the proposed ARS 115 deviates from generally accepted accounting principles and refers to incorrect accounting standards. This is likely to create confusion and inconsistent application across banks if these inconsistencies remain.

Further, some banks are likely to need greater implementation periods than the proposed 1 January 2021 due to the complexity of their organisation and the need for further clarification in the final reporting standard (see Appendix 1 for list of items for clarification). Clarification of ARS 115 requirements timing will have a material impact on when banks can go live with the reporting and the ABA encourages APRA to provide this clarification as soon as possible.

The ABA asks APRA to provide clarity on when the new ARF 115 SMA report kicks off with compliance date of 1st January 2021 i.e. if this is applicable for March 2021 quarter reporting.

In addition, the ABA would like APRA to ensure that the final ARS 115 is consistent with the outcomes of other data consultations currently underway. In particular, the consultation on data confidentiality and data reporting periods which are relevant to ARS 115. At present, these consultations have not yet concluded. However, the ARS 115 will need to be updated to reflect the relevant consultation outcomes before being finalised.

The ABA also asks APRA to provide the opportunity to the banks to have sit down discussion(s) with APRA on specific feedback.

The ABA specific feedback focuses on:

- Clarification of financial statements and dates
- Frequency of data updates
- Prior period reporting
- Due date for submission of the quarterly return
- Treatment of operational risk losses
- Data confidentiality
- Treatment of dividend income
- Prior period information for mergers and acquisitions

Each of these are discussed below.

2. Clarification of financial statements and dates

2.1 Audited data

The ABA supports an appropriate level of assurance over the data provided to APRA. However, we would like to seek some clarity over the coverage and frequency of those audits.

In particular, we would like APRA to provide clarification on whether they intend ADIs to complete the ARF 115 return using balances that form part of totals in the audited financial statements or audited data (pursuant to APS 310 *'Audit and Related Matters'*).

For most ADIs, the financial year-end audit opinion is expressed on the financial statements, consolidated at a group level, not on the general ledger data or as at the regulatory return data. Therefore, the financial statement audit opinion would not provide assurance over financial data consolidated at regulatory level 1 and level 2, or on any of the additional adjustments required to make the financial data fit for the ARF 115 regulatory return.

ABA recommendation

We recommend that APRA provide clarification on whether they intend ADIs to complete the ARF 115 return:

i) using balances that form part of net profit or loss and total assets per the audited financial statements, or

ii) using data that is subject to audit in accordance with APS 310.

This clarification will have flow on implications for the frequency of any audit requirements (i.e. annual or quarterly), and the number of years of data, as the first return will contain three years' worth of data.

3. Frequency of data updates

The ABA understands that the proposed ARS 115 requires the use of "audited year-end financial" data, but also requires the report be submitted quarterly. Given this, the ABA understands this to mean that the data in the report should be updated once a year and left static for the remaining three quarters. This is because audits are performed once a year on financial year-end data.

ABA recommendation

The ABA would like APRA to confirm its interpretation of how audited year-end financial data will be used in quarterly reporting as part of the final reporting standard or bilaterally with banks.

4. Prior period reporting

4.1 Inclusion of two years' prior periods reports in the first return

The ABA understands that due to the different reporting requirements in APS 115 compared to existing audited returns (APS 330 and financial statements), a new regulatory return audit will be required. Retrospective audit of three years' worth of data will impose considerable operational challenges and increase compliance cost which may outweigh the benefit.

ABA recommendation

The ABA recommends that APRA consider allowing ADIs to submit the first-year return without submitted two years' prior return information and build up to the submission of a form containing the three-year view over the first three years' ARF 115 returns.

5. Due date for submission of the quarterly return

The ABA understands that ARS 115 is proposing a 35-calendar day reporting due date. However, 35 calendar days will not be sufficient to provide end-of-year audited accounts. Given this, banks will be unlikely to meet this proposed reporting deadline at the end of the financial year.

As noted earlier, the reporting due date needs to be consistent with the outcomes of the quarterly data reporting consultation. Consistent with the ABA's response to the consultation on proposed changes to due dates of quarterly reporting for ADIs, APRA's proposed 35 calendar day reporting due date will be difficult for many banks to implement. In particular, it would be difficult and more costly to attempt to complete an additional audit on the ARS 115 data within 35 calendar days of the financial year-end (if required).

Further, the banks have different financial year-ends, and therefore differing dates for completion of the audit of their annual financial statements. Given this, we request clarification about the financial periods to be included in the first submission.

ABA recommendation

We recommend APRA take a pragmatic approach to the reporting date requirements of ARS 115 and allow at least a 45-calendar day due date from the end of the reporting period. The ABA also requests clarification about the financial periods to be included in the first submission.

6. Treatment of operational risk losses

The ABA would like to seek clarification from APRA on the treatment of operational risk losses in ARS 115. According to APS 115 s19, the other operating expenses (OOE) line item "includes operational loss events". It is not immediately apparent whether APRA intends for this line item to include all operational risk loss events or just to include those loss events that are already booked as OOE.

The accounting for operational risk loss events is based on generally accepted accounting principles. This requires the refund of a fee charged to a customer in error, to be accounted for as a reversal of fee income, whereas internal costs related to processing the refund are in expenses.

Operational risk losses are recognised across various income statement line items in the profit or loss and hence are not separately disclosed as a standalone P&L line item identifiable from the profit and loss statement. The general ledger (GL) bookings required to account for operational risk loss events are varied and can be complex. Therefore, these losses tend to be spread throughout the financial accounts and are not easily separated into a separate line item.

It would be a resource intensive process to attempt to identify and reverse all these journal entries in order to split operational risk losses out of the normal financial accounts and into a separate line item.

ABA recommendation

We propose that APRA allows banks to continue reporting operational risk losses consistent with their accounting treatment. We understand that APRA may want to use its discretion to require banks to strip certain large losses out of their accounts and into this OOE line item where the impact on the SMA calculation would have a material effect on capital, most likely on a best endeavours basis.

Please note that this proposal is consistent with the requirements in the APS 115, since the standard states that OOE "includes operational loss events" not that OOE 'includes all operational loss events'. We would therefore only require clarification of APRA's intentions rather than a change to the standard.

7. Data confidentiality

The ABA notes that ARS 115 requires the reporting of commercially sensitive P&L data. It is sensitive as the public release of this information can have broader market implications affecting investor confidence as well as reducing competition by informing competitors about the nature of the ADIs business.

ABA recommendation

As noted earlier, the ABA is making a submission to the current consultation on data confidentiality where we recommend that sensitive financial data such as P&L remain confidential. The ABA also recommends that sensitive financial data reported under ARS 115 also be treated confidentially.

8. Treatment of dividend income

The ABA would like to clarify whether the BI component should include dividend income arising from intercompany dividends (e.g. Level 2 banking subsidiaries) in the Level 1 SMA calculation. In our view, holding operational risk capital for these dividends received by the parent ADI at Level 1 would be considered overly punitive given that the operational risk capital requirement for these subsidiaries business activities should be reflected only at Level 2, also noting that the parent ADI already holds regulatory capital for its investment in certain subsidiaries at Level 1 (with the investment in other subsidiaries being deducted from regulatory capital).

The ABA notes that the proposed ARS 115 will require reporting at regulatory level 1 and level 2. As a result, intercompany funding, dividends and other transactions may cause movements in BI components. However, APS 115 is currently silent on the treatment of intercompany transactions within the group. That said, the Basel Committee on Banking Supervision provides the following:

BCBS OPE 10 'Calculation of RWA of Operational Risk', Definitions & Application, Clause 10.4 provides that *"At the consolidated level, the standardised approach calculations use fully consolidated BI figures, which net all the intragroup income and expenses. The calculations at a sub-consolidated level use BI figures for the banks consolidated at that particular sub-level. The calculations at the subsidiary level use the BI figures from the subsidiary."*

ABA recommendation
The ABA recommends providing further clarification on the treatment of intercompany transactions between regulatory bank levels and whether these are treated as external transactions for the sake of ARS 115.

8.1 Dividend income from associates

The ABA notes that APS 115.0 defines "dividend income from investments in stocks and funds not consolidated in the ADI's financial statements, including dividend income from … associates." However, by following general accounting consolidation principles at a group level, any dividend income received by an investor entity (e.g. an ADI parent) from an associate is recognised as a reduction in the carrying amount of the investment, as the underlying equity-accounted profits have been recognised in profit or loss at a group level.

ABA recommendation

To avoid a double count of associate equity-accounted income and the receipt of dividends, we would recommend that the reference to associates be removed from the definition of dividend income.

9. Mergers, acquisitions and divestments

The ABA welcomes the inclusion of adjustment fields to take account of events such as divestments, mergers and acquisitions. However, the ABA would like to seek clarification from APRA on a number of points regarding these prior period adjustments.

9.1 Definition of mergers, acquisitions and divestments

The ABA notes that banks need to make an adjustment related to mergers, acquisitions and divestments. However, the standard does not provide clarity around the definition of these items. For example:

- Does a merger/acquisition only include those transactions that result in the control of another entity (i.e. a subsidiary) or business, or is the intention to be broader than this (i.e. to include acquisitions of equity that results in a minority shareholding in an entity, and/or specific assets such as a loan portfolio)?
- Will a divestment only comprise sales of an entity/business or would it also include wind-downs (full or partial) of businesses within the Group.

ABA recommendation

Given the uncertainty about the definitions, the ABA would like clarification as to the types of transactions that APRA is expecting to be included.

9.2 Estimation of prior period data and audit requirement

The ABA understands that the purpose of prior period adjustments is to reflect the risk of the new asset or business going forward. However, the ABA notes that, in many cases, it may not be possible to source accurate prior period data to calculate the ARS 115 impact of mergers, acquisitions and divestments. For example, the acquisition of a loan portfolio may not come with prior period financials that could be appropriately adjusted and fed into ARS 115. In addition, it may be difficult to receive audit assurance over the prior period data for these assets as it relates to ARS 115.

ABA recommendation

The ABA recommends that banks be allowed to submit best effort estimates of prior period adjustments for mergers, acquisitions and divestments, and not require audit over these numbers. For example, if the appropriate prior period data did not exist, a bank may take an estimate from the current year data and apply it to the prior years, or take an average of the available data and apply it across the prior years.

In order to ensure these estimates are fit for purpose we propose that a bank submit their estimates to APRA for approval on a case by case basis.

9.3 Application to APRA for adjustments

APS 115 states that adjustments to prior periods as the result of divestments are "subject to APRA's approval". However, it is not immediately clear whether the same approval is required for adjustments resulting from mergers and acquisitions.

ABA recommendation

We would propose that APRA approve adjustments for mergers and acquisitions on a case by case basis where estimates are used (see above).

9.4 Materiality threshold for adjustments

The ABA would like clarification on the threshold of materiality for determining which mergers, acquisitions, and divestments require prior period adjustments in ARS 115. The standards are currently silent on the materiality level for application to APRA. However, attempting to adjust for all mergers, acquisitions, and divestments would be a resource intensive task.

ABA recommendation

The ABA recommends providing guidance on the materiality of SMA capital impacts that would require a bank to make prior period adjustments for mergers, acquisitions, and divestments.

9.5 Restating for accounting changes

The draft ARF 115 form appears to indicate that the prior two years of results are locked down and cannot be re-stated after the fact. The ABA seeks to clarify whether this means that APRA does not expect ADIs to restate prior period results in the ARF 115 form for changes in accounting requirements that are applied retrospectively.

ABA recommendation

The ABA requests that APRA give further consideration on the implications following a change in accounting treatment. For example, when AASB 16 *Leases* recently came into effect there was an option to account for the change prospectively or retrospectively. This election that could be made for accounting purposes, changes the future net profit or loss, as under retrospective accounting treatment, amounts are taken to retained earnings rather than to future profit or loss.

Australian Banking Association

Appendix 1 – Specific questions for clarification

Item No.	Category	Context	Question
1	Treatment of bank levy	Bank Levy	Could APRA provide clarification on the treatment of the Bank Levy.
2	Clarification of interest expense on lease liabilities	Interest expense on lease liabilities	Could APRA clarify the definition of interest expense on lease liabilities specifically in relation to losses on leased assets and the split of interest income into 1.1.2.1, 1.1.2.2 and 1.1.2.3.
3	Definition of interest earning assets	Interest Earning Assets	Could APRA clarify what it considers to be captured under “interest earning assets”.
4	Operational Loss Events	ARF 115 Instructions – 7 describes Other Operating Expenses as “Means expenses and losses from ordinary banking operations not included in other business indicator items but of a similar nature, or from operational loss events.”	Could APRA clarify the distinction between “losses from ordinary banking operations” and “operational loss events”.
5	Expenses	Expenses for establishing provisions	Could APRA clarify what are the expenses related to establishing provisions / reserves for operational loss events to be included in this category.
6	Interest income	Breakdown of interest income	Could APRA provide clarification behind the split of Interest Income into 1.1.1.1, 1.1.1.2 and 1.1.1.4.
7	Interest income	The definition of interest income suggests that it should include all interest income on financial assets and other interest income but only has rows for Interest income calculated using the effective interest rate and income relating to leases.	Could APRA clarify the definition of interest income.