

# Prudential Standard

## **APS 222 – Associations with Related Entities**

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# Prudential Standard

## APS 222 - Associations with Related Entities

### Objective

*This standard aims to ensure that ADIs take account of risks associated with the corporate group of which they are a member and are not exposed to excessive risk as a result of their associations and dealings with related entities.*

Note: Foreign ADIs (which have the same interpretation as in Division 1B of the *Banking Act 1959*) operating through branches in Australia are not subject to this Standard, except for the requirements set out in paragraphs [16-26](#) and [34](#) below.

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### Principles

#### Monitoring of Contagion Risk

1. Associations between an ADI and other members of a conglomerate group (defined in accordance with [AGN 110.1 – Conglomerate Group](#) for the purposes of this Standard) to which it belongs may give rise to the potential of contagion risk. That is, the possibility that problems arising in other group members may compromise the financial and operational position of the ADI. In assessing the level of risk of such associations, APRA will have regard to the following factors:
  - (a) the financial strength of the group;
  - (b) the nature of business conducted in group entities;
  - (c) the quality of management and systems and particularly, risk management across the group;

- (d) the level of financial and operational interdependence across the group, particularly between regulated and unregulated entities;
  - (e) whether other members of the group are regulated entities (i.e. any entity directly regulated by APRA or by an equivalent banking, insurance or similar prudential regulator overseas) and the quality of regulation;
  - (f) the ratings (where applicable) of unregulated entities in the group;
  - (g) badging and product distribution arrangements which might link the ADI to the fortunes of other entities in the group; and
  - (h) other relevant factors to be considered on a case-by-case basis.
2. To ensure that contagion risk is kept at a modest level, an ADI should have adequate systems, policies and procedures in place to manage, monitor and control all forms of risks arising from the association beyond those arising from direct financial dealings with group members. The risks range from reputational risk and legal risk arising from the use of a common brand name (group badging), cross selling of products, or perception of support provided by an ADI to group members and vice versa, to operational risk arising from the use of common services provided by or to other group members.

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### **Group Risk Management<sup>1</sup>**

3. For conglomerate groups headed by an ADI, the Board of the ADI is responsible for ensuring that comprehensive policies and procedures are in place to measure, manage, monitor and report overall risk at a group level. To ensure that existing Board-approved policies and the relevant controls remain adequate and appropriate for managing and monitoring overall group risk, the Board or a board committee should review them regularly (at least annually) to take account of changing risk profiles of group entities. Any material changes to group risk management policies must be approved by the Board.

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<sup>1</sup> Paragraphs 3 to 7 apply to an ADI that heads a conglomerate group (see [AGN 110.1](#)). Where an ADI forms part of a conglomerate group headed by an authorised non-operating holding company, the requirements set out in paragraphs 3 to 5 apply to the ADI and its subsidiaries.

4. The Board of an ADI should ensure that the ADI establishes appropriate policies, systems and procedures to monitor compliance with APRA's prudential requirements on a group basis. To facilitate conglomerate group supervision by APRA, an ADI should:
  - (a) provide APRA with the following group information:
    - (i) details of group members (e.g. name, place of incorporation, board composition, nature of business and any other additional information required by APRA for a better understanding of the risk profiles of individual group members);
    - (ii) management structure of the group (including key risk management reporting lines);
    - (iii) intra-group support arrangements (e.g. a specific guarantee of the obligations of an entity in the group);
    - (iv) intra-group exposures (see [paragraph 13](#) below); and
    - (v) other information as required by APRA from time to time for effective supervision of the group;
  - (b) notify APRA immediately after it becomes aware of any breach of a prudential standard requirement or a condition of a banking authority (whether by an ADI in the group or by the group) and of any circumstances that might reasonably be seen as having a material impact and potentially adverse consequences for an ADI in the group or for the overall group;
  - (c) advise APRA in advance of any proposed changes to the composition or operations of the group with the potential to materially alter the group's overall risk profile (this should include any proposed changes to the ADI's stand-alone operations); and
  - (d) obtain APRA's prior approval for the establishment or acquisition of a regulated presence domestically or overseas.
5. An ADI is required to provide APRA with descriptions of its group risk management policies and the procedures used to measure and control overall group risk (including any material changes thereto). The ADI should, as best practice, disclose in the group's full published annual report each year an outline of its group risk management policies,

including the policies governing dealings between the ADI and other group members.

6. Within 3 months<sup>2</sup> of an ADI's annual balance date, its chief executive should provide APRA with a declaration, endorsed by the Board, which attests that<sup>3</sup>:
  - (a) the Board and management of the ADI have identified the key risks facing the overall group;
  - (b) the Board and management of the ADI have established policies addressing those risks (including where appropriate prudent limits on risk exposures) and have systems and procedures in place to monitor and manage those risks;
  - (c) these policies have been effectively implemented and are adequate having regard to the risks they are designed to control; and
  - (d) the descriptions of group risk management policies, systems and procedures provided to APRA are accurate and current.
7. If an ADI feels it needs to qualify the declaration prescribed in [paragraph 6](#) above, it would need to explain the reasons for the qualifications, as well as provide plans for corrective action.

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### **Dealings with Related Entities**

8. For the purpose of this Standard, all entities controlled (whether directly or indirectly) by an ADI (other than subsidiaries that form part of the "Extended Licensed Entity"<sup>4</sup>), or by the ultimate domestic parent of an ADI (including the parent entity itself) represent a "related entity" of an ADI. Consistent with the definition of a conglomerate group set out in [AGN 110.1](#), a "related entity" excludes the foreign parent(s) of an ADI, the foreign parent's overseas based subsidiaries and their directly owned

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<sup>2</sup> 4 months for non-disclosing entities.

<sup>3</sup> This attestation is in addition to any attestation required to be made by the chief executive of the ADI under [APS 310 – Audit & Related Arrangements for Prudential Reporting](#). It is open to the chief executive of an ADI to provide a combined attestation covering both the ADI and the overall group.

<sup>4</sup> Subject to satisfying the criteria set out in [AGN 222.1](#), an ADI and any APRA-approved subsidiaries will be treated as a single entity (i.e. the Extended Licensed Entity) for the purposes of measuring the ADI's exposures to related entities.

non-ADI entities operating in Australia<sup>5</sup>. Where appropriate, APRA may deem that other entities (and their subsidiaries) represent a “related entity” of an ADI.

9. The Board of an ADI should establish, and monitor compliance with, policies governing all dealings with related entities. The policies, including any material changes thereto, should be provided to APRA.
10. Board policies on related entity dealings should, at a minimum, include:
  - (a) a requirement that the ADI should address risks arising from dealings with related entities as strictly as it would address its risk exposures to unrelated entities (see [paragraph 11](#) below);
  - (b) prudent limits on exposures to related entities at both an individual and aggregate level (see [paragraph 13](#) below);
  - (c) procedures for resolving any conflict of interest arising from such dealings;
  - (d) requirements relating to exposures generated from an ADI’s participation in group operations (see [paragraphs 23 to 26](#) below); and
  - (e) requirements relating to the transparency of third-party dealings associated with related entities.

(As a general rule, an ADI should not undertake any third-party dealings with the prime purpose of supporting the business of related entities.)
11. Where the terms and conditions applying to an ADI’s dealings with related entities are inconsistent with the benchmark for unrelated entities, they must be approved by the Board of the ADI with justifications fully and clearly documented in a register for inspection by APRA at any time.
12. As a general rule, an ADI should not:
  - (a) hold unlimited exposures to related entities either in aggregate or at an individual entity level (e.g. a general guarantee of the obligations of a related entity); or

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<sup>5</sup> Prudential limits on the aggregate exposure of an ADI to these entities are set out in [APS 221 – Large Exposures](#).

- (b) enter into cross-default clauses whereby a default by a related entity on an obligation (whether financial or otherwise) is deemed to trigger a default of the ADI in its obligations.
13. In determining limits on acceptable levels of exposure to related entities, the Board of an ADI should have regard to:
- (a) the level of exposures which would be approved for unrelated entities of broadly equivalent credit status; and
  - (b) the impact on the ADI's stand-alone capital and liquidity positions, as well as its ability to continue operating, in the event of a failure of any related entity to which the ADI is exposed.
14. An ADI must satisfy APRA that it has adequate systems and controls in place for identifying, reviewing, monitoring and managing exposures arising from dealings with related entities. APRA may require an ADI to put in place additional internal controls, a more robust reporting mechanism and/or to maintain a higher capital ratio if it is not satisfied with the adequacy of the ADI's systems and controls.

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### **Provision of Support**

15. An ADI may provide support to related entities (and vice versa) provided such support is undertaken in accordance with the prudential requirements set out in paragraphs 10 to 13 above in relation to the policies governing an ADI's dealings with related entities<sup>6</sup>. An ADI must avoid giving any impression of ADI support unless there are formal legal arrangements in place providing for such support.
16. A foreign ADI may provide support to its subsidiaries operating in Australia (and vice versa). However, it must avoid giving any impression of support to these subsidiaries unless there are formal legal arrangements in place providing for such support. Where a foreign ADI wishes to give a general guarantee to its Australian subsidiaries, it should be able to demonstrate to APRA that the home supervisor is aware of the obligations and has no objection to the transaction.

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<sup>6</sup> Paragraph 15 also applies to provision of support by a foreign-owned ADI to non-ADI entities operating in Australia directly owned by the ADI's foreign parent or by the parent's subsidiaries (and vice versa).

## Group Badging<sup>7</sup>

17. An ADI and other members in the conglomerate group to which it belongs may use a common brand name provided:
  - (a) section 66 of the *Banking Act 1959* governing the use of restricted expressions in Australia by an ADI or by any other person is complied with; and
  - (b) the roles and responsibilities of different group members are clearly disclosed (see [paragraph 19](#) below) to reduce the possibility of creating an impression that a non-ADI member of the group is an ADI, or that (contrary to the legal position) a group member is guaranteed or supported by an ADI in the group.
  
18. APRA may require an entity not to use a particular brand name if that would give rise to a prudential concern having regard to the following factors:
  - (a) the presence of appropriate disclosures;
  - (b) the type of entities involved (whether regulated or unregulated);
  - (c) the manner in which various products and services are marketed; and
  - (d) the types of customers involved.
  
19. To enable counterparties to clearly distinguish dealings with an ADI and those with other non-ADI group entities, the ADI should ensure that financial transactions (e.g. sales of financial products) between unregulated group members and external counterparties are accompanied by clear, comprehensive and prominent disclosure that:
  - (a) the group member with whom the counterparty is dealing is not an ADI and that the member's obligations do not represent deposits or other liabilities of the ADI in the group; and
  - (b) the ADI does not stand behind the group member, unless support is provided for in a formal legal agreement (see [paragraphs 15 and 16](#)

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<sup>7</sup> All paragraphs under this section also apply to foreign ADIs (and their subsidiaries operating in Australia), and to non-ADI entities operating in Australia directly owned by the foreign parent of an ADI or by the parent's subsidiaries.

above). The nature and limit of such support should also be prominently disclosed where appropriate.

20. For group members involved in funds management and securitisation, prudential requirements in relation to disclosure and separation are set out in [APS 120 – Funds Management & Securitisation](#).

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### **Distribution of Products<sup>8</sup>**

21. Where an ADI distributes the financial products of other group members (or third parties), it must ensure that the identity of the product provider is prominently displayed in the relevant marketing material and product documentation such that:
- (a) there is no confusion created in customers' minds about the respective roles and responsibilities of the ADI and the product provider; and
  - (b) it does not give any impression that the product is guaranteed or otherwise supported by the ADI, unless a formal legal agreement is in place to this effect (see paragraphs 15 and 16 above).
22. While other members of the group (or third parties) may distribute the products of an ADI member in the group in either an agent or representative capacity, the ADI concerned must ensure that:
- (a) appropriate disclosures are present detailing the respective roles of the ADI and the other group members or third parties (see [paragraph 21](#) above); and
  - (b) the other group members (or third parties) do not, unless otherwise agreed with APRA (and supported by appropriate contractual arrangements – see [paragraph 23](#) below), assume any key decision-making function of the ADI (e.g. in relation to creditworthiness) in distributing the ADI products.

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<sup>8</sup> Refer footnote 7.

## Participation in Group Operations<sup>9</sup>

23. An ADI may participate in group operations (e.g. share premises with other group members, centralise back-office functions, outsource services to other group members, etc.) provided:
- (a) dealings with related entities (and other parties) arising from participating in group operations are appropriately documented in written agreements (outsourcing of the ADI's material business activities to a related entity must satisfy the prudential requirements set out in [APS 231 – Outsourcing](#) and [AGN 231.1 – Managing Outsourcing Arrangements](#));
  - (b) such operations do not lead to any confusion in the mind of customers;
  - (c) these operations do not impinge on the safety and soundness of the ADI as a stand-alone entity; and
  - (d) the arrangements covering participation in group operations do not impinge on the ability of APRA to obtain information required for the supervision of an ADI or pertaining to the group as a whole, and there must be a clear obligation under the written arrangements for any service provider to comply with any direction given by APRA in relation to the operations of an ADI.
24. An ADI must satisfy APRA that its ability to readily conduct its business in a sound fashion would not be jeopardised should premises or other services (such as computer systems) provided by related entities become unavailable (i.e. an ADI must have backup arrangements and contingency planning in place). An ADI should be able to demonstrate that the level of reliance placed on premises, services, etc. provided by related entities, or the provision of services to related entities, does not compromise the ability of the ADI to identify and manage its risks on a stand-alone basis.
25. The Board of an ADI should establish policies and procedures to address risks arising from the ADI's participation in group operations. The policies, including any material changes thereto, should be provided to APRA. As a general rule, an ADI should address these risks on the same basis as it would if such operations were undertaken by unrelated entities.
26. An ADI's participation in group operations should be approved by the ADI's Board. In approving such activities, the Board should:

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<sup>9</sup> Refer footnote 7.

- (a) have regard to the risks presented to the ADI on a stand-alone basis as a result of its participation in such activities; and
- (b) be satisfied that any exposures to related entities which might arise have been appropriately captured in measures of the ADI's exposures to related entities.

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### **Prudential Limits on Intra-group Exposures**

27. Exposures of an ADI or, where applicable, of an Extended Licensed Entity (see [AGN 222.1](#)) to related entities (see definition in [paragraph 8](#) above) are subject to the following limits<sup>10</sup>:

- (a) related ADIs (including overseas based equivalents)
  - (i) exposure to individual related ADI – 50% of Level 1 capital base; and
  - (ii) aggregate exposure to all related ADIs – 150% of Level 1 capital base;
- (b) other related entities
  - (i) exposure to other individual regulated related entity (i.e. any related entity other than an ADI or overseas based equivalent directly regulated by APRA or by a foreign equivalent) – 25% of Level 1 capital base;
  - (ii) exposure to individual unregulated related entity – 15% of Level 1 capital base; and
  - (iii) aggregate exposure to all related entities (other than related ADIs and related overseas based equivalents) – 35% of Level 1 capital base.

28. For the purposes of [paragraph 27](#) above, an ADI's (or Extended Licensed Entity's) exposure to a related entity is the aggregate of all claims, commitments and contingent liabilities arising from on- and off-balance sheet transactions (in both the banking and trading books) with the related entity, and

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<sup>10</sup> These limits are measured against an ADI's Level 1 (i.e. stand-alone) capital base calculated in accordance with [APS 111 – Capital Adequacy: Measurement of Capital](#).

- (a) includes (but is not limited to):
- (i) outstanding balances of all loans and advances;
  - (ii) all unused advised off-balance sheet commitments (refer Attachment A to [AGN 112.2](#) for examples of these commitments), whether revocable or irrevocable;
  - (iii) the credit equivalent amounts of all market-related contracts (calculated in accordance with [AGN 112.2](#) or [AGN 112.3](#) where netting applies<sup>11</sup>); and
  - (iv) any equity investment in the related entity not deducted from the ADI's Level 1 (stand-alone) capital for capital adequacy purposes (see [APS 111 – Capital Adequacy: Measurement of Capital](#));
- (b) excludes:
- (i) exposures of the ADI to, including equity investments in, subsidiaries that form part of the Extended Licensed Entity (see [AGN 222.1](#))<sup>12</sup>;
  - (ii) exposures (including equity investment) deducted from the ADI's Level 1 (stand-alone) capital for capital adequacy purposes (see [APS 111 – Capital Adequacy: Measurement of Capital](#));
  - (iii) exposures to the extent that they are secured by cash deposits (subject to satisfying the criteria set out in Attachment B to [AGN 112.1](#) for the purpose of this Standard);
  - (iv) exposures to the extent that they are guaranteed by governments, or secured by government securities (subject to satisfying the conditions set out in paragraphs 9, 12, 13, 14 and 15 of [AGN 112.1](#) for the purpose of this Standard);
  - (v) exposures arising in the course of settlement of market-related contracts; and

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<sup>11</sup> In determining an ADI's (or Extended Licensed Entity's) exposure to a related entity, netting by novation and close-out netting are permissible for market-related contracts provided all the requirements set out in [AGN 112.3](#) for bilateral netting are met.

<sup>12</sup> However, an ADI is required to report these exposures to APRA as part of the normal prudential reporting framework (see [paragraph 33](#) below).

- (vi) exposures to the extent that they have been written off or specifically provided for.

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### **Approval Requirements**

- 29. An ADI must obtain APRA's prior approval for any proposed exposures in excess of the prescribed limits set out in [paragraph 27](#) above. Such approval will only be granted on an exceptional basis. The ADI concerned must be able to satisfy APRA why the proposed exposure(s) might reasonably be expected not to expose the ADI (or Extended Licensed Entity) to excessive risk. APRA may impose a higher minimum capital ratio on the ADI at the stand-alone level (see [APS 110 – Capital Adequacy](#)) to compensate for the additional risk that may be associated with the proposed exposure(s).

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### **Prior Consultation Requirements**

- 30. An ADI should consult with APRA before:
  - (a) establishing or acquiring a subsidiary (other than an entity which is to be used purely as a special purpose financing vehicle for the ADI);
  - (b) committing to any proposal to acquire (whether directly or indirectly) more than 10% of equity interest in an entity which operates in the field of finance; and
  - (c) taking up equity interest in an entity arising from the work-out of a problem exposure where:
    - (i) this exceeds 0.25% of the ADI's Level 2 Tier 1 capital (calculated in accordance with [APS 111 – Capital Adequacy: Measurement of Capital](#)); or
    - (ii) this will result in the ADI acquiring (whether directly or indirectly) more than 10% of equity interest in the entity; or
    - (iii) this will result in the ADI's aggregate investment in non-subsidiary entities which are not operating in the field of finance exceeding 5% of the ADI's Level 2 Tier 1 capital

(calculated in accordance with [APS 111 – Capital Adequacy: Measurement of Capital](#)).

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### **Notification Requirements**

31. An ADI must notify APRA immediately of any breach of the prudential limits on exposures to related entities prescribed in [paragraph 27](#) above, including remedial actions taken or planned to deal with the breach.
32. An ADI should report any equity investments that are not subject to the prior consultation requirements set out in [paragraph 30](#) above to APRA retrospectively.

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### **Reporting**

33. An ADI must provide APRA each quarter (or more frequently if required by APRA) with information on its (or the Extended Licensed Entity's) exposures to related entities (including the ADI's exposures to subsidiaries that form part of the Extended Licensed Entity) in a form to be determined by APRA from time to time. Where necessary, APRA may impose additional reporting requirements on the ADI.
34. A foreign ADI must provide APRA each quarter (or more frequently if required by APRA) with information on its exposures to its subsidiaries operating in Australia in a form to be determined by APRA from time to time. Where necessary, APRA may impose additional reporting requirements on the foreign ADI.

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