DISCUSSION PAPER

Revisions to the related entities framework for ADIs

July 2018

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Executive summary

An ADI's associations with related entities can expose the ADI to substantial risks, including through financial and reputational contagion. Complex group structures may also adversely impact on the ability of an ADI to be resolved in a sound and timely manner.

The existing requirements established by the Australian Prudential Regulation Authority (APRA) for authorised deposit-taking institutions (ADIs) governing associations with related entities are a long-standing and important component of the prudential framework for ADIs. The requirements have not been materially updated since 2003.

Since then, international developments have emphasised that deficiencies in prudent controls can expose an ADI to substantial risks in relation to its related entities. For example, during the global financial crisis, reputational pressures meant that overseas banks were inclined to support, often beyond their legal obligations, certain funds management vehicles that suffered significant falls in value or impaired liquidity. In effect, these banks were exposed to substantial credit and liquidity risks through their associations.

APRA is proposing to update its existing related entities framework to account for lessons learned from the global financial crisis on mitigating the flow of contagion risk to an ADI, particularly from related entities, and incorporate changes to the revised large exposures framework, published in December 2017. This update includes revisions to the:

- definition of related entities to capture all entities (including individuals) that may expose the ADI to contagion and step-in risk. This is expected to impact all ADIs;

- measurement of exposures to related entities by aligning with requirements in the revised large exposures framework. This is expected to impact all ADIs;

- prudential limits on exposures to related entities. APRA is proposing to adjust the size of the limits and align the capital base used in limit calculations with the more appropriate Tier 1 base now used in the revised large exposures framework. The proposal is expected to primarily impact ADIs that have a small capital base;

- extended licensed entity (ELE) framework by amending the criteria for a subsidiary to be consolidated in an ADI's ELE. This is expected to impact those ADIs that utilise the ELE framework and particularly those that have offshore ELE subsidiaries, which hold or invest in assets; and

- reporting requirements to capture more prudential information on substantial shareholders and subsidiaries that are treated as part of an ADI's ELE. This is expected to impact more complex ADIs.

The impact of the proposed changes on each ADI will depend on, among other factors, the number and size of entities captured by the proposed definition of related entities; the size of exposures to related entities relative to an ADI's capital base; the extent to which an ADI undertakes business through subsidiaries; and differences in how an ADI currently measures its exposures to related entities compared with the proposed methodology.

APRA is cognisant of the impact these reforms may have on ADIs and is particularly interested in receiving feedback on whether the proposed reforms best meet APRA's mandate to improve financial safety and financial system stability without material adverse impacts on efficiency or competition. ADIs are encouraged to provide alternative proposals where it is considered that an alternative will better meet the prudential objectives.

APRA is seeking feedback on the proposed amendments with the consultation period open until 28 September 2018. Given the potentially material nature of the proposals, APRA anticipates that a finalised framework would come into force on 1 January 2020, with transition potentially offered to ADIs that are most impacted by the reforms.

Glossary

ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 111	*Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*
APS 120	*Prudential Standard APS 120 Securitisation*
APS 120 (2006)	*Prudential Standard APS 120 Funds Management and Securitisation*, which was determined under Banking (prudential standard) determination No 6 of 2006 and revoked by Banking (prudential standard) determination No. 11 of 2007
APS 221	*Prudential Standard APS 221 Large Exposures*
APS 222	*Prudential Standard APS 222 Associations with Related Entities*
ARS 221.0	*Reporting Standard ARS 221.0 Large Exposures*
ARS 222.0	*Reporting Standard ARS 222.0 Exposures to Related Entities*
ASIC	Australian Securities and Investments Commission
Basel Committee	Basel Committee on Banking Supervision
Basel large exposures framework	*Standards: Supervisory framework for measuring and controlling large exposures*, April 2014
Board	Board of Directors
Corporations Act	*Corporations Act 2001*
CPS 220	*Prudential Standard CPS 220 Risk Management*
Crisis Management Act	*Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*
ELE	Extended Licensed Entity, within the meaning given in *Prudential Standard APS 001 Definitions*
Level 3 Head	Level 3 Head has the meaning given in *Prudential Standard 3PS 001 Definitions*

Total Capital	Regulatory Capital
SPV	Special purpose vehicle

Chapter 1 — Introduction

1.1 Background

APRA's related entities framework for ADIs, set out in *Prudential Standard APS 222 Associations with Related Entities*, is a complement to the risk-based capital framework for ADIs and forms an important component of an ADI's risk management framework in line with *Prudential Standard CPS 220 Risk Management*.

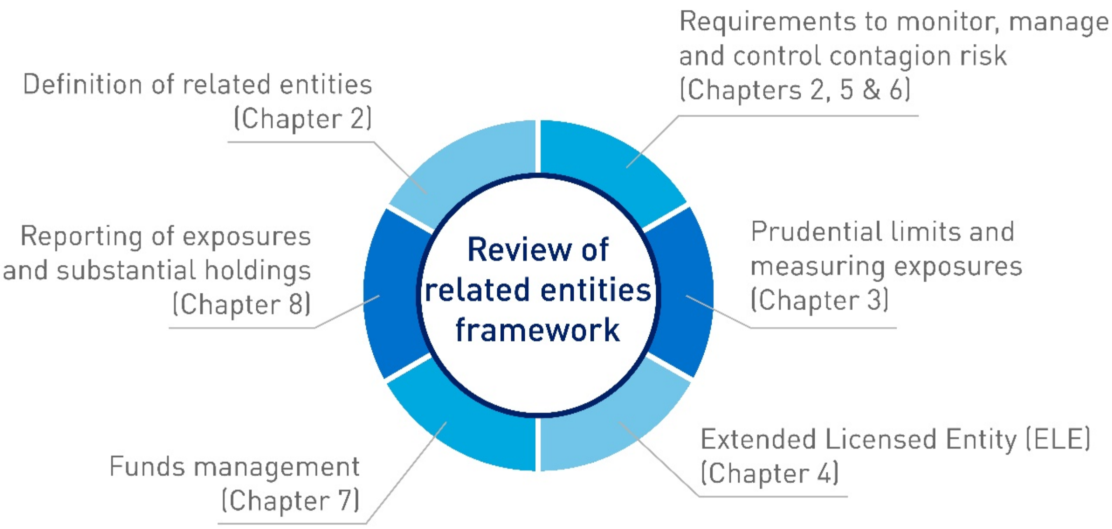
APS 222 sets minimum requirements for ADIs in relation to the monitoring, management and control of risks which arise from associations with related entities (e.g. financial and reputational contagion) and also includes prudential limits on intra-group exposures. APS 222 was last materially updated in 2003.

In December 2017, APRA published in final form revisions to its prudential framework for large exposures in *Prudential Standard APS 221 Large Exposures* (revised APS 221). The changes to the large exposures framework were motivated by the Basel Committee on Banking Supervision's (Basel Committee) revised *Supervisory framework for measuring and controlling large exposures* (Basel large exposures framework), released in April 2014, and by APRA's desire to modernise its prudential framework.

APRA now proposes to make adjustments to the related entities framework to reflect the revisions to the large exposures framework, as well as the change in the operating environment and contagion risks that ADIs are exposed to.

1.2 Proposed revisions to the related entities framework

APRA's review of the related entities framework encompasses the following areas:



Proposed changes to the framework aim to strengthen the ability of ADIs to monitor, limit and control risks arising from transactions and other associations with their related entities and include proposals to:

- broaden the definition of related entities to capture all entities (including individuals) that may expose the ADI to conflicts of interest and contagion risk, such as substantial shareholders (which has the meaning given in section 9 of the *Corporations Act 2001*) and individuals on the Board of Directors (Board);
- revise the limits on exposures to related entities (including related individuals);
- introduce minimum requirements on contagion risk assessments;
- introduce stronger requirements to mitigate reputational contagion flowing from one group entity to another, or to the ADI, particularly where these entities share common logos or brands with the ADI;
- align requirements for the measurement of exposures to related entities with those applying to exposures to unrelated entities in the revised Large Exposures framework;
- address risks arising from subsidiaries, which hold or invest in assets, that are treated as part of an ADI's extended licensed entity (ELE); and
- update reporting requirements to align with the proposed amendments to the prudential standard and capture more prudential information on substantial shareholders and subsidiaries that are treated as part of an ADI's ELE .

1.3 Balancing APRA's objectives

APRA's mandate includes balancing the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, and, in balancing these objectives, promote financial system stability in Australia. APRA considers that, on balance, the proposals in this discussion paper will enhance prudential outcomes, improve financial safety and promote financial system stability.

PRIMARY OBJECTIVES	
Financial safety ⬆	Financial system stability ⬆
Improved: Stronger requirements for ADIs to identify, measure, monitor, control and limit risks arising from associations with related entities will protect ADIs and depositors against conflicts of interest and contagion risks. Financial safety is also supported by improved information and transparency on material exposures through enhanced reporting requirements.	**Improved:** Financial system stability is expected to be improved through stronger criteria for identifying related entities; clearer requirements on measuring contagion risks to the ADI; tighter prudential limits on exposures to related entities; and enhanced requirements to control for reputational contagion related to group badging.

OTHER CONSIDERATIONS	
Efficiency ⬇	**Marginally reduced:** Tighter exposure limits may affect ADIs' ability to undertake certain exposures with related entities. Some ADIs may need to seek external funding for operations currently performed within subsidiaries, or to restructure operations. These impacts may be offset by the proposals encouraging simple and more efficient corporate structures.
Competition ⬇	**Marginally reduced:** The proposals relating to the ELE framework may reduce the ability of an ADI's subsidiaries to compete in offshore jurisdictions.
Contestability ⟷	**No change:** The proposals do not limit the ability of new entrants to seek to become an ADI.
Competitive Neutrality ⟷	**No change:** The proposals in this paper have no impact on competitive neutrality.

Chapter 2 — Scope and risk monitoring

The global financial crisis highlighted that deficiencies in prudential controls can expose an ADI to substantial contagion risks, in relation to its related entities, through various channels:

- Financial contagion - an ADI may have a concentration of exposures to its related entities. This has the potential to cause significant losses to the ADI, particularly if one or more of its related entities that share common sources of risk were to face significant difficulties. This risk is exacerbated by the potential for conflicts of interest to arise during the origination or ongoing management of an exposure to a related entity.

- Reputational contagion - where an ADI's group members face operational or financial difficulties, investors may perceive that the group member is the ADI or the ADI may step in to support its group members beyond formal legal arrangements. This is exacerbated where group members share a common brand name with the ADI and may also occur where an ADI has a material business association with another entity.

- Other avenues of contagion – conflicts of interest that may lead to relaxing of risk controls and oversight for transactions with related entities; complex group structures that negatively impact the ability of an ADI's subsidiaries to be resolved in a sound and timely manner; operational risks arising from the sharing of management and other service arrangements; the purchase or sale of assets in relation to related entities; and the transfer of risk through credit risk mitigation.

With these lessons learned, particularly in relation to factors that can expose an ADI to contagion and conflicts of interest, APRA considers it is appropriate to review the scope of entities captured by APS 222 requirements and enhance systems and controls aimed at identifying, monitoring and controlling the spread of contagion to ADIs from its related entities.

2.1 Definition of a related entity

The current definition of a related entity includes entities controlled by the ADI and the ultimate domestic parent of an ADI (including the parent entity itself). APRA proposes to closely align the definition of a related entity with the definition in the Basel Committee's *Core principles for effective banking supervision*. The proposed definition, set out in Table 1, 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.

Table 1 — Current and proposed definition of an ADI's related entities

	Current APS 222	Proposed APS 222
Definition of an ADI's related entities	A related entity of an ADI includes all entities controlled (whether directly or indirectly) by: • an ADI (other than subsidiaries that form part of the ELE); or	A related entity of an ADI includes, but is not limited to, any of the following: • an associate of the ADI (within the meaning given in section 50 AAA of the *Corporations Act 2001*);

	• the ultimate domestic parent of an ADI (including the parent entity itself).	• an entity which is directly or indirectly controlled by the ADI, and any of the entity's associates; • an entity which directly or indirectly controls the ADI, and any of the entity's associates; • a substantial shareholder of the ADI and the substantial shareholder's associates; • a related individual of the ADI and the related individual's relatives, and their associates; and • an entity that exposes the ADI to step-in risk to an extent that the ADI's capital or liquidity positions would be materially impacted if the ADI were to step in to support the entity.

APRA proposes to align the definition of control with the equivalent definition in the revised APS 221. This will enhance the ability of ADIs to identify related entities and ensure consistency across ADIs as well as within the prudential framework.

The proposed definition of a related entity expands upon the existing definition as it recognises that contagion can flow through multiple channels. For example, loans or facilities provided by an ADI to its substantial shareholders or related individuals may expose the ADI to heightened risks or conflicts of interest if they are not assessed on an arm's length basis.

APRA notes that members of ADIs such as credit unions, building societies and mutual banks that are owned by members rather than shareholders (mutually owned ADIs) are not intended to be captured by the proposed definition of a related individual and in most circumstances, will not be captured. However, where it is assessed that a member exercises control over an ADI, the member will be required to be treated as a related individual and the ADI's associations with the individual will be captured by APS 222's requirements.

The new definition requires ADIs to treat a substantial shareholder, and the substantial shareholder's associates, as a related entity. This, and the other components of the expanded definition, ensures that all entities which expose the ADI to conflicts of interest, and potential contagion, are appropriately captured. APRA 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 counterparties, and the custodian bank does not exercise control over individual voting rights.

Under the proposed APS 222, an ADI would also be required to treat an entity as a related entity if it exposes the ADI to step-in risk under the circumstances that the ADI's capital or liquidity positions would be materially impacted if the ADI were to step in to support the entity. APRA considers this is appropriate as such arrangements expose the ADI to risks similar to that borne from dealings with related entities (refer to Chapter 2.5).

2.2 Assessing contagion risks from group structures and related entities

The current APS 222 does not include minimum requirements in relation to ADI assessments of contagion risks from its group structures and related entities. APRA considers that it is appropriate for ADIs to be required to effectively identify, assess and monitor the spread of contagion risk from their group structure and related entities.

Under the proposed APS 222, ADIs will be required to assess, at least annually, a number of contagion risk factors. This will include assessing material risks arising from the ADI's group structure; entities within the group; interlinkages across the group; and group badging and other business arrangements.

The proposals will ensure that ADIs implement robust and consistent risk assessments of their group structure and related entities, which reflect material risks underlying the ADI's related entities.

2.3 Policies on dealings with related entities

Under the current APS 222, an ADI's Board policies on related-entity dealings must address a number of areas such as the inclusion of prudent limits and a requirement to address risks from related entities in a manner consistent with how it would address its risk exposures to unrelated entities. APRA proposes some enhancements to these requirements.

In addition to existing requirements, an ADI's policies on dealings and associations with related entities must, at a minimum, cover:

- limits on write-offs of exposures to related entities, which are to be determined with regard to the level of exposures that would be approved for unrelated entities of an equivalent credit status and the impact on the ADI's stand-alone capital and liquidity positions in the event of a failure of a related entity;
- the circumstances in which the limits relating to exposures and write-offs may be exceeded and the authority and processes required for approving such excesses (e.g. by the ADI's Board or a board committee);
- the authority and processes required for the approval and maintenance of group structures, where the ADI is the head of a group, and establishing and acquiring subsidiaries;
- processes for identifying entities that expose the ADI to step-in risk (refer to Chapter 2.5); and
- procedures to address material risks to the ADI arising from the ADI distributing the financial products of a third party and vice-versa (e.g. disclosures to third parties to ensure that the roles and responsibilities of the ADI are not confused with the product provider).

2.4 Provision of support

Under the current APS 222, an ADI (including a foreign ADI) must not provide support to its related entities (or its subsidiaries) unless there are formal legal arrangements in place providing for such support. Such support must also be in accordance with the requirements in APS 222.

APRA proposes to maintain current requirements to mitigate the potential for an ADI to be exposed to substantial contagion risk from its involvement with related entities. An ADI that provides support to its related entities beyond any legal obligation may give the impression that it supports the performance of the related entity. Additionally, an ADI's own capital and liquidity positions may be exposed to substantial losses where support is provided to a related entity that experiences significant difficulty, and the ADI's claim is subordinated to third-party creditors.

The extent of contagion to the ADI may be further aggravated by the risk of such support not being provided on arm's length terms. Accordingly, APRA considers that there must be clear limitations, expressed in legal documentation, governing the extent of an ADI's dealings with any related entity.

APRA also proposes specific requirements on the purchase and sale of assets of, and securities in relation to, a related entity. Whilst an ADI may have formal legal arrangements in place with a related entity providing for support, the level of purchases of assets and securities issued by a related entity may constitute the ADI providing capital support to the related entity. APRA considers that in such cases, it will be prudent for the ADI to recognise the risks of these transactions in the risk-based capital framework by deducting the value of such support from the ADI's Common Equity Tier 1 Capital.

2.5 Step-in risk

The global financial crisis emphasised that during a downturn, ADIs may have incentives beyond contractual obligations or equity ties to step in to support other entities. This risk arises particularly when an ADI would prefer to support an entity rather than allowing it to fail and expose the ADI to reputational contagion.

APRA proposes to adopt the definition of step-in risk in the Basel Committee's *Guidelines on the Identification and management of step-in risk*. Under this proposal, an ADI is exposed to step-in risk if the ADI is likely to step in to support an entity beyond any legal obligation. Accordingly, the risks that an ADI is exposed to through its connection with the entity is similar to those arising from control or ownership of the entity.

Step-in risk may expose an ADI to substantial losses. APRA proposes that if an entity exposes an ADI to step-in risk, where the ADI's capital or liquidity positions would be materially impacted if the ADI were to step in to provide support, the entity will be required to be treated as a related entity. The ADI's associations and exposures to the entity would then be subject to the requirements and prudential limits in the proposed APS 222.

To meet the requirements relating to step-in risk, ADIs will need to first develop procedures to identify what entities are material enough to be subject to the scope of the step-in risk assessment. Where an entity meets this requirement and the ADI is likely to step in to support an entity beyond any legal obligation, the entities will be required to be treated as related to the ADI. To assess the likelihood of an ADI stepping in to provide support to an entity, APRA proposes that an ADI would need to consider the factors in paragraph 18 of the proposed APS 222. At a high level, the factors consider the degree of association an ADI may have with an entity and expectations that an ADI would support an entity in a stress scenario.

To help APRA understand the impact of this proposed reform, ADIs are invited to provide information on the number and size of entities that may be caught by the step-in risk requirements (refer to Chapter 9.2).

Chapter 3 — Exposures and limits

Consistent with changes to APS 221 released in December 2017, APRA proposes to revise the methodology for measuring exposures to related entities, the capital base on which the prudential limits are based and the size of those limits. The limits in the proposed APS 222 are set out in Table 2. ADIs would continue to apply the prudential limits to related entities on a Level 1 basis; that is, the ADI and subsidiaries that are included as part of its ELE.

Table 2 — Current and proposed limits on exposures to related entities

	Current APS 222	Proposed APS 222
Related ADIs (or overseas-based equivalents)		
Exposure to individual related ADI	50% of Total Capital	25% of Tier 1 Capital
Aggregate exposure to all related ADIs	150% of Total Capital	75% of Tier 1 Capital
Other related entities		
Exposure to other individual regulated related entities (other than related ADIs and related overseas-based equivalents)	25% of Total Capital	25% of Tier 1 Capital
Exposure to individual unregulated related entity (including related individuals)	15% of Total Capital	15% of Tier 1 Capital
Aggregate exposure to all related entities (other than related ADIs and related overseas-based equivalents, and including related individuals)	35% of Total Capital	35% of Tier 1 Capital

3.1 Limits on exposures to related ADIs

3.1.1 Exposure to individual related ADI

Under APS 222, an ADI's exposure to an individual related ADI is limited to 50 per cent of the ADI's Regulatory Capital (Total Capital). APRA proposes to replace Total Capital with Tier 1 Capital as the measurement basis for the limit as Tier 1 Capital can absorb unexpected losses on a 'going-concern' basis. This is also consistent with the revised APS 221.

Given the reduction in the prudential limit in the revised APS 221 for exposures to an unrelated ADI, from 50 per cent of Total Capital to 25 per cent of Tier 1 Capital, APRA proposes that the same limit should also apply for exposures to an individual related ADI. An exposure limit of 25 per cent of Tier 1 Capital is appropriate to further limit the degree of contagion to which an ADI is exposed, consistent with APRA's view that only in exceptional circumstances should an ADI have an exposure to an entity higher than 25 per cent of an ADI's Tier 1 Capital.

Under existing requirements, ADIs are already required to address risks arising from related entities as strictly as those arising from unrelated entities. Limits must also be determined in regards to the level of exposures which would be approved for unrelated entities of an equivalent credit status. Under existing exposure levels, APRA does not expect this revision to have any material impact.

3.1.2 Aggregate exposure to all related ADIs

With the proposed reduction in the limit on an exposure to an individual related ADI from 50 per cent to 25 per cent, APRA also proposes that the limit on aggregate exposures to all related ADIs should be reduced consistently. APRA proposes that the limit be revised downwards from 150 per cent of an ADI's Total Capital to 75 per cent of Tier 1 Capital.

An ADI operating with an aggregate exposure of up to 150 per cent of its Total Capital to its related ADIs is exposed to substantial contagion risk; this is particularly the case if these entities were all to face issues in a crisis (e.g. due to common branding). A prudential limit of 75 per cent of Tier 1 Capital is considered to be more appropriate. Based on current exposure levels, APRA does not expect this revision to have any material impacts. However, ADIs are invited to provide information on the potential current or future impacts of this proposal (refer to Chapter 9.2).

3.2 Limits on exposures to other related entities

Consistent with changes to the prudential limits on exposures to related ADIs, APRA considers that prudential limits on exposures to other related entities should also be based on Tier 1 Capital. However, the percentage limits are proposed to be unchanged otherwise, as set out in Table 2.

The limit for 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. This is expected to primarily impact smaller ADIs.

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. However, equity exposures and capital support provided to regulated related entities that have not been deducted from the ADI's Level 1 capital, according to requirements in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*, will continue to be included in the measurement. For exposures to related entities that are excluded from measurement under prudential limits, APRA proposes to align the criteria for these with those excluded under the revised APS 221.

Specifying clear requirements in APS 222 to measure exposures will ensure consistency across ADIs when monitoring and limiting contagion risks. Where an ADI has an exposure to a related entity that is a structured vehicle, and the ADI is required to look through the structured vehicle to its underlying assets, the ADI must allocate its exposures to the underlying assets to the relevant prudential limits in APS 221 and APS 222.

Chapter 4 — The extended licensed entity framework

APRA applies its prudential requirements to both the ADI on a stand-alone basis and to the consolidated group of which the ADI is a member. The ELE framework is a feature of the broader framework that allows an ADI to consolidate certain subsidiaries within the Level 1 ADI for prudential purposes even though they are legally separate to the ADI on a stand-alone basis and would not otherwise be consolidated. Accordingly, an ELE includes the ADI and all subsidiaries (ELE subsidiaries) that have been approved to be part of the ELE. This structure was established to enable efficiencies for legal, taxation and other regulatory compliance reasons in circumstances where its use would not otherwise change the risk profile of the ADI on a stand-alone basis.

APRA is concerned that use of the ELE regime has created added complexity in ADI group structures, hindered supervision over ELE subsidiary activities and has the potential to complicate resolution activities in a wind-up of the ADI. As a result, APRA has taken this opportunity to conduct a review of the ELE framework.

4.1 Current ELE arrangements

Under the current requirements, to be treated as an ELE subsidiary, the subsidiary must be managed as effectively as a division of the ADI; the subsidiary must have no material liabilities to entities outside the ELE, where the subsidiary holds or invests in assets; and there must be no obstacles to winding up a subsidiary and repatriating its assets and funds to the ADI. These conditions are required to be met at all times, including during financial stress. As a result of a subsidiary being treated as part of an ADI's ELE, the ADI's exposures and equity investments (including capital support) provided to its ELE subsidiaries are exempt from the intra-group exposure limits in APS 222 and requirements in APS 111 relating to deductions from the ADI's capital.

In February 2015 APRA wrote formally to ADIs that have overseas subsidiaries in their respective ELEs. These letters highlighted that any applications for new overseas ELE subsidiaries would be expected to demonstrate a very high level of assurance that there are no legal or regulatory barriers to the transfer of assets or funds back to the ADI, particularly in times of stress.

In July 2016, APRA requested information from 11 ADIs that use the ELE framework, with a view to ensuring that current ELE arrangements are robust. Themes arising from the information request, as well as APRA's concerns over current ELE arrangements, are discussed below.

A substantial portion of ELE subsidiaries are established overseas for the purpose of holding or investing in assets (asset-driven ELEs), with the remainder being established to fund the ADI through the issuance of securities. A predominance of subsidiaries are operating companies and undertake a range of activities such as leasing, providing mortgages and managing securitisation schemes.

Impact on supervision

Whilst some responses to APRA's information request indicated that the ELE framework is used for efficiency of regulatory reporting, others suggested that the framework is used predominantly as a means to exceed the intra-group limits in APS 222. APRA's view is that in many cases ADIs did not demonstrate convincing or substantive reasons for using ELEs.

A small number of ADIs have a material number of ELE subsidiaries. The growth in the number of ELE subsidiaries suggests that the ELE framework is not being used on an exceptions basis for efficiency purposes. Over time, the growth in the number and size of ELE subsidiaries has also led to a significant increase in the complexity of some ADIs. In APRA's view, this has hindered APRA's ability to effectively supervise the ADI and assess its soundness as a stand-alone legal entity.

This complexity is compounded where there are multiple levels of subsidiaries within an ELE, and where ELE subsidiaries are funded by other ELE subsidiaries; such funding structures have reduced the ability of APRA to trace underlying risks. There are also questions regarding whether subsidiaries are currently meeting requirements to not establish material liabilities to other entities outside an ELE.

Based on its review, APRA considers that the activities conducted through domestic ELE subsidiaries do not pose material prudential risks. Use of offshore ELE subsidiaries, however, has led to a reduction in the transparency of activities undertaken by ADIs through those ELEs. Use of offshore ELE subsidiaries has also led to a substantial portion of activities, conducted in offshore jurisdictions, not being prudentially regulated by host supervisors.

Resolution of offshore asset-driven ELE subsidiaries

Around half of the ELE subsidiaries are incorporated in offshore jurisdictions. The global financial crisis provided several examples of overseas insolvency proceedings limiting parent entities from accessing assets and funds in their overseas subsidiaries. Based on this evidence, APRA is concerned that Australian ADIs, would not at all times, be able to meet the requirements for inclusion of certain business lines within an ELE, therefore posing potentially substantial risks in a resolution scenario.

APRA recognises that such issues relating to the resolution of an ADI with overseas subsidiaries are not limited to the ELE framework. These concerns will also arise in conglomerate structures that include branch and subsidiary entities. However, this discussion paper will address the matter as it relates to the ELE framework.

The number of subsidiaries included in some ELEs also poses substantial questions over the ability of an ADI (or the statutory manager of an ADI) to wind up and resolve impacted subsidiaries in a sound and timely manner, and whether the senior management of an ADI is able to monitor the operations of a large number of ELE subsidiaries to the same extent as the operations of the ADI itself.

4.2 Proposed revisions to the ELE framework

APRA considers that a number of revisions are required to mitigate risks relating to the complexity of the ELE framework and the resolvability of offshore ELE subsidiaries which hold or invest in assets.

APRA proposes a number of amendments, set out in Table 3.

Table 3 — Proposed changes to the ELE framework

Remove the ELE-eligibility of overseas subsidiaries unless they have been established to borrow on behalf of the ADI	Removing the eligibility of these subsidiaries is expected to enhance APRA's prudential supervision of an ADI's banking activities. This also aligns with the current requirement that there are no legal or regulatory barriers, or any other material risks, to the transfer of any assets or funds back to the ADI from an ELE subsidiary. As offshore asset-driven ELE subsidiaries are not able to meet this requirement, they should not be eligible to form part of an ADI's ELE. This proposal builds upon expectations in APRA's February 2015 letter to ADIs which have offshore ELEs, into APS 222. Subsidiaries which are incorporated domestically but fund offshore business and assets (e.g. a holding company funding an underlying offshore subsidiary) would also be ineligible to be treated as part of an ELE. APRA's view is that the risk in these arrangements is equivalent to an ADI directly funding an ELE subsidiary that undertakes offshore business.
Simplify the number and size of subsidiaries treated as part of an ELE	Where an ADI seeks to treat a subsidiary as part of an ELE, the ADI must satisfy APRA that the overall number and size of subsidiaries proposed to be included in the ELE does not undermine the ability of the ADI and its subsidiaries to be managed and resolved in a sound, timely and prudent manner, and for APRA to assess the soundness of the ADI as a stand-alone legal entity.
Simplify the level of subsidiaries eligible to be treated as part of an ELE	Where an ADI seeks to include a holding company as part of its ELE, the ADI may also include the holding company's subsidiaries as part of the ELE. However, APRA proposes that only the first level of subsidiaries below a holding company are eligible to be treated as part of the ELE.
Simplify the funding structure of ELE subsidiaries which hold or invest in assets	An ELE subsidiary which holds or invests in assets must not undertake borrowings from, or establish liabilities (either on- or off-balance sheet) to, entities other than the parent ADI. Taxation liabilities, employee entitlements, administration and operating expenses of the subsidiary are exempt from this requirement.

APRA expects that for ADIs which currently have holding companies treated as part of the ADI's ELE, there should be no material capital impacts due to existing rules in Attachment D of APS 111 requiring ADIs to look through their equity exposures to direct and indirect equity exposures for capital adequacy purposes.

These proposed changes may require ADIs with offshore subsidiaries in their ELE to restructure the composition of their groups. Some ADIs may require a transition period before the existing legal and funding arrangements can be unwound.

In addition, with 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.

Due to the extent of the proposed revisions, APRA invites submissions to give consideration to the materiality of the reform including the extent of transition required, as well as whether there may be alternative means of amending the ELE framework that would better address APRA's concerns.

Chapter 5 — Group badging and other matters

5.1 Group badging

Under the current APS 222, non-ADI members in the ADI's conglomerate group may share a common brand name with the ADI provided that financial transactions between non-ADI group members and external counterparties are accompanied by clear, comprehensive and prominent disclosures to distinguish between the role of the ADI and the group member; and section 66 of the *Banking Act 1959* governing the use of restricted expressions is complied with.

The appearance of common brand names between an ADI and its group members, however, can give external counterparties (e.g. investors) the impression that the group member is the ADI and vice-versa or that the ADI supports the performance of the group member beyond any formal legal arrangements. This exposes the ADI to substantial reputational risks, particularly if its group members were to face financial and operational difficulties.

Due to the long-standing nature of these provisions and the need for operational efficiencies, APRA proposes to continue to allow ADIs and other group members to share a common brand name provided enhanced disclosure requirements are met (refer to Chapter 5.2).

APRA proposes to also retain the power to require the ADI not to share a particular brand name with its group members, subject to some modifications, if the use of a common brand name gives rise to a prudential concern. In exercising this power, APRA will have regard to a number of additional factors relating to the risk profile, reputation and associations of a group member.

5.2 Disclosures

The current APS 222 includes specific requirements relating to disclosures that must be made to ensure that external counterparties can distinguish between the roles and responsibilities of an ADI and another group member which shares a common brand name with the ADI. APRA proposes to maintain existing disclosure requirements as they help to mitigate significant reputational risk, subject to some revisions.

APRA also proposes to require ADIs 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)* (refer to Chapter 7 on revisions to funds management requirements). APRA considers that as group badging arrangements can result in substantial reputational contagion, it would be prudent to implement stronger disclosure requirements and ensure consistency across all group members.

In developing disclosures, an ADI will also have regard to Australian Securities and Investments Commission's (ASIC's) *Regulatory Guide 168 Disclosure: Product Disclosure Statements (and other disclosure obligations)* as well as relevant requirements in the *Corporations Act 2001.*

ADIs are invited to provide information on the effectiveness of existing disclosure practices to ensure that the proposed changes are fit for purpose (refer to Chapter 9.2).

5.3 Participation in group-wide operations

Under the current APS 222, an ADI that participates in group operations (e.g. shares premises with other group members, uses centralised back-office functions, outsources services to other group members), must have policies and procedures to address risks arising from its participation and meet other requirements such as being able to identify and manage its risks on a stand-alone basis.

Under *Prudential Standard 3PS 222 Intra-Group Transactions and Exposures* (3PS 222), where a prudentially regulated institution participates in Level 3 group-wide activities, a Level 3 Head must meet a range of requirements relating to the prudential soundness of the regulated institution. APRA proposes to largely keep the current requirements in APS 222 as these requirements remain appropriate to ensure that operational risks from other entities do not impact the safety and soundness of the ADI's operations. Minor wording changes have been made, where necessary, to align with the requirements in 3PS 222.

Chapter 6 — Notification and approval requirements

6.1 Prior notification requirements

The current APS 222 requires an ADI to consult with APRA prior to commencing certain transactions such as the establishment or acquisition of subsidiaries; acquiring a 20 per cent or more equity interest in an entity; and taking up equity interest in an entity from the work-out of a problem exposure.

Consistent with changes in the revised APS 221, APRA proposes to change the requirement for consultation with APRA to prior notification to APRA for such activities. This means that ADIs will need to notify APRA prior to undertaking the transactions listed in paragraph 37 of the proposed APS 222. A prior notification requirement is also proposed when committing to a related entity exposure that is greater than, or equal to, 10 per cent of an ADI's Tier 1 Capital.

The intention of prior notification is to allow ADIs additional operational flexibility compared to prior consultation. Flexibility is also proposed with the additional provision allowing APRA to determine that an ADI is not required to notify APRA prior to undertaking certain transactions below a specified threshold.

Minor wording revisions have also been made to clarify that establishing or acquiring a subsidiary is subject to prior notification requirements except in circumstances where an entity is used purely as a special purpose vehicle (SPV) to provide finance to the ADI (e.g. an SPV that is established with the sole purpose of funding the ADI through the issuance of securities into the market, on behalf of the ADI).

6.2 Notification requirements

APRA proposes minor revisions to the notification requirements in APS 222. Consistent with the requirements in the revised APS 221, ADIs will be required to notify APRA immediately of any of the breaches of the prudential limits of APS 222. ADIs will be allowed to notify APRA within three months of undertaking an equity investment that has not been subject to the prior notification requirements.

A more material revision is proposed for the requirement to notify APRA immediately after becoming aware of any circumstances that might reasonably be seen as having a material impact or potentially adverse consequences for an ADI in the group or the overall group. It is proposed that an ADI must notify APRA upon undertaking material changes to the structure of a group which is headed by the ADI. Such situations may include the restructure of a number of subsidiaries to other parts of the group or the sale of a material portion of the ADI's business. An ADI must also notify APRA where there is a significant breach of, or material changes in, the ADI's policies on dealings with related entities. APRA considers that such circumstances require greater prudential oversight.

6.3 Approval requirements

In the current APS 222, an ADI must obtain approval from APRA prior to taking on exposures in excess of the prudential limits or other specific limits imposed by APRA. Approval is also required prior to the establishment or acquisition of a regulated presence (such as a branch or subsidiary) domestically or overseas. The proposed APS 222 maintains the current requirements subject to minor wording changes.

Chapter 7 — Funds management activities

Prior to 2008, APRA imposed requirements on the funds management activities of ADIs via *Prudential Standard APS 120 Funds Management and Securitisation* (APS 120) (2006). On 1 January 2008, APS 120 (2006) was revoked and replaced with *Prudential Standard APS 120 Securitisation*. In 2007, APRA released a letter to all ADIs outlining its expectation that ADIs would continue to comply with APS 120 (2006) in relation to their funds management activities.

Most of the requirements in APS 120 (2006) are superseded by existing requirements in APS 222 (in relation to arm's length dealings and the provision of support), and *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) on the treatment of capital support provided to related entities. Other requirements which are not specifically addressed are discussed in this chapter.

APRA considers that the prudential requirements relating to an ADI's involvement in funds management continue to remain relevant. Significant involvement of an ADI in the operations a fund can expose the ADI to potential losses, equivalent to the exposure that the ADI would have if it were operating the fund itself, and give the perception that an ADI supports a fund's performance. As demonstrated during the global financial crisis, in the event that a fund in an ADI's group were to experience difficulty, the ADI may face reputational risks as well as unexpected credit or liquidity risks if the ADI were to step in.

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. Where an ADI has an exposure to a funds management vehicle that is not a related entity, that ADI would be required to apply relevant requirements in the prudential framework on exposures to unrelated entities.

7.2 Separation and disclosure

To ensure there is effective separation between an ADI and a funds management vehicle, and to protect deposits placed with an ADI against risks posed by funds management activities, APRA considers it would be prudent to maintain the separation requirements from APS 120 (2006). Accordingly, an ADI must not act as a manager, responsible entity, approved trustee, trustee or any similar role in relation to funds management.

Requirements relating to arm's length dealings and the provision of support to related entities in the existing APS 222 will also apply to dealings between an ADI and its funds management vehicles. This involves setting clear limitations in legal documentation governing the extent of an ADI's involvement or dealings with a funds management vehicle. In addition, ADIs must ensure that dealings with the funds management vehicle's investors (e.g. loans from the ADI to those investors) are provided on an arm's length basis, and on market terms and conditions, to avoid giving investors the perception that the ADI supports a fund.

On requirements relating to disclosures, APRA proposes to simplify these by aligning them with other disclosure requirements in APS 222 (refer to Chapter 5.2). APRA considers it appropriate to maintain requirements relating to disclosures as they will help to limit reputational contagion to the ADI.

7.3 Purchase of securities, and underwriting

APS 120 (2006) contained several requirements relating to ADIs underwriting funds, and on the amount of securities or units of a fund that ADIs can purchase. APRA views these requirements as necessary to enhance the separation between an ADI and a fund, and limit the extent at which an ADI may be exposed to substantial losses, particularly during a downturn, as a result of taking up a position in a fund.

APRA proposes to make minor revisions to existing requirements relating to ADIs acting as an underwriter to the issue of securities by a funds management vehicle. Whilst it may be reasonable for ADIs to assist the smooth operation of new businesses, clear requirements are needed to ensure that an ADI's involvement with a fund does not extend to what investors might perceive as an ADI supporting the fund.

Under the proposed APS 222, where an ADI underwrites the issue of a fund's securities, the ADI would be required to reduce its holding to below 20 per cent within two months; this is compared to existing requirements which are set at three months. An ADI that does not meet certain operational requirements in relation to an underwriting facility must deduct the value of that facility from the ADI's Level 1 Common Equity Tier 1 Capital.

7.4 Provision of liquidity facilities

Currently, a liquidity facility provided to a funds management vehicle that fails to meet certain prudential conditions must be treated as credit enhancements and deducted from the ADI's Level 1 Common Equity Tier 1 Capital.

APRA proposes to maintain these requirements in APS 222. Certain liquidity facilities provided to funds management vehicles may be used for purposes beyond accounting for timing mismatches in payments and receipts. During a downturn, where investors are seeking redemptions on their investments, liquidity facilities may also be called upon for market disruption purposes. In such cases, APRA's view is that the use of the facility would result in an ADI indirectly supporting the activities of a fund. This exposes the ADI to substantial economic losses and should be deducted accordingly.

Conditions requiring a liquidity facility to be deducted from the ADI's Level 1 Common Equity Tier 1 Capital include, among others, the repayments of the facility to the ADI being subordinated to other investors and if the facility could be used to fund additional assets held by a vehicle or the final scheduled repayment of investors.

Chapter 8 — Reporting of exposures to related entities

Currently, under *Reporting Standard ARS 222.0 Exposures to Related Entities* (ARS 222.0), ADIs are required to report their 10 largest exposures to related entities and ELE-eligible subsidiaries, respectively. Foreign ADIs which operate as branches in Australia must also report any exposures of the Australian branch to their head office, individual overseas branches, as well as to individual Australian and overseas subsidiaries of the parent entity.

Broadly, the proposed revisions to ARS 222.0 are reflective of changes made in the revised APS 221 and *Reporting Standard Large Exposures ARS 221.0* (revised ARS 221.0). Exposures are proposed to be measured and reported in alignment with the revised exposure measurement methodology which was finalised in APS 221 in December 2017.

The number of exposures proposed to be reported under ARS 222.0 would also be consistent with ARS 221.0. ADIs would be required to report their top 20 largest exposures to their related entities. In terms of the break-down of each of the largest 20 exposures to a related entity, APRA also proposes that ADIs report the legal entity identifier of each related entity, where available, and on- and off-balance sheet exposures.

For ELE subsidiaries, APRA is proposing that ADIs report exposures to all ELE subsidiaries and the assets and liabilities of each ELE subsidiary established to hold or invest in assets, under ARS 222.0. The proposed reporting requirements on ELE subsidiaries will enhance transparency over these subsidiaries and APRA's capacity to supervise them.

With the proposed revision to the definition of related entities, APRA also considers it appropriate to capture information on ADIs' substantial shareholders (within the meaning of section 9 of the *Corporations Act 2001*). APRA proposes that ADIs report the extent of a substantial shareholder's holdings in the ADI and any material changes in ownership, under ARS 222.0. The intent of these revisions is for ADIs to report entities that can exert influence over the ADI through the exercise of their voting rights rather than material holdings held through arrangements which have the potential to mask ownership or control.

The proposed reporting standard, reporting forms and instructions are available on the APRA website.

Chapter 9 — Consultation and next steps

9.1 Request for submissions and cost-benefit analysis information

APRA invites written submissions on the proposals set out in this discussion paper. Written submissions should be sent to ADIpolicy@apra.gov.au by 28 September 2018 and addressed to:

General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence.

Automatically generated confidentiality statements in emails do not suffice for this purpose.

Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under *the Freedom of Information Act 1982* (FOIA).

APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

APRA asks that all stakeholders use this consultation opportunity to provide information on the compliance impact of the proposals, and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any changes to compliance costs incurred by businesses as a result of APRA's proposals.

Consistent with the Government's approach, APRA will use the methodology behind the Commonwealth Regulatory Burden Measure to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at https://rbm.obpr.gov.au/.

APRA requests that respondents use this methodology to estimate costs to ensure the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their costs assessment to APRA, respondents should include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that institutions would undertake due to foreign regulatory requirements or in their ordinary course of business.

9.2 Consultation questions

Submissions are welcome on all aspects of the proposals in this discussion paper.

In addition, specific areas where feedback on the proposed direction would be of assistance to APRA in finalising its proposals are outlined in Table 4.

Table 4 — Consultation questions

Chapter 1 — Introduction	1.1 Are there any other potential impacts from the proposals that should be considered in balancing APRA's objectives?
Chapter 2 — Scope and risk monitoring	2.1 What is the potential impact of the expanded related entities definition? 2.2 What is the number and size of entities caught by the step-in risk criteria and what adjustments to the criteria could be made to ensure the requirements are balanced with the business need to ensure efficiency? 2.3 How can the requirements to assess contagion risk be streamlined or enhanced?
Chapter 3 — Exposures and limits	3.1 What are the potential impacts of the proposed prudential limits and revisions to the measurement of exposures?
Chapter 4 – The extended licensed entity framework	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? 4.2 What transition period would be required to mitigate the impacts of the proposals in this paper? 4.3 What additional or alternative measures could be taken to mitigate the risks and concerns expressed regarding offshore ELE subsidiaries?
Chapter 5 — Group badging and other related matters	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? 5.2 Are acknowledgements of disclosures effective in ensuring information is understood? Can these be implemented via electronic means? 5.3 What alternative measures could be taken to enhance requirements on group badging and disclosures to mitigate reputational impacts to the ADI?
Chapter 6 — Notification and approval requirements	6.1 Are there any operational issues to implementing the prior notification, notification and approval requirements and, if so, how can these be addressed?
Chapter 7 — Funds management activities	7.1 How often do ADIs provide underwriting facilities to funds management entities and are there any reasons why an ADI cannot

	reduce its holdings in a fund to below 20 per cent within two months of an underwriting facility being exercised?
Chapter 8 — Reporting of exposures to related entities	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?
Chapter 9 — Consultation and next steps	9.1 What proposals will require a transition period beyond the proposed commencement date of 1 January 2020?

9.3 Next steps and implementation

Following the consideration of submissions from ADIs, APRA expects to release the final prudential and reporting standards in late 2018. APRA expects that the prudential and reporting requirements would commence from 1 January 2020 and in certain circumstances be subject to transition.

Attachment A — Policy options and estimated comparative net benefits

APRA has considered various options in developing proposed revisions to its requirements in APS 222 and the associated reporting standard, reporting forms and instruction guides. The potential costs and net benefits of the various options are addressed below. APRA intends to incorporate feedback from industry on the options and provide estimated comparative net benefits in a Response Paper on revisions to the related entities framework for ADIs when it finalises the framework.

Information provided in response to APRA's request for cost-benefit analysis information (refer to Chapter 9.1) will be used by APRA to quantify the change in regulatory burden using the Regulatory Burden Measurement Tool, and will inform calculations of the net benefits of the proposals.

The following table outlines APRA's considerations relating to the various dimensions of this consultation. For each dimension, options are provided that consider making either no change or a comprehensive change. The third column then provides APRA's preferred approach.

	Option 1: No change	Option 2: Comprehensive change	Preferred approach
Definition of an ADI's related entity	**Keep existing definition of related entities** • This option results in no immediate compliance costs for ADIs • Current deficiencies in the framework may continue and ADIs may not identify all entities which expose them to contagion and conflicts of interest (refer to Chapter 2.1).	**Align the definition of related entities with the Basel Core Principles** • This option would align the definition with that in the Basel Committee's *Core principles for effective banking supervision* (Basel Core Principles). • This would require ADIs to identify the full extent of entities which expose them to contagion and conflicts of interest. This also addresses any inconsistencies with international frameworks. • All ADIs would be exposed to compliance costs relating to updating policies, processes and systems and training employees to identify the revised scope of related entities. • The benefits of this option to prudential safety and financial stability are expected to exceed the	**Option 2** • Option 2 is considered both a balanced and preferred approach to reviewing the definition of an ADI's related entities. • The costs associated with implementing the proposal are not expected to outweigh the benefits to prudential safety and APRA's supervision of contagion risk and conflicts of interest.

		immaterial costs associated with implementation.	
Measuring exposures to related entities	**Keep the existing measurement basis** • This option results in no immediate compliance costs for ADIs. • However, there may be indirect costs as a result of not applying the exposure measurement requirements under the Basel Committee on Banking Supervision's *Supervisory framework for measuring and controlling large exposures* (Basel large exposures framework). • Other implications include operational inefficiencies for ADIs arising from inconsistent exposure measurement requirements across APRA's prudential framework and a lack of comparability of exposures to related entities across ADIs.	**Align the measurement basis with APS 221** • This option aligns the measurement of exposures with the measurement of exposures to unrelated entities in the revised *Prudential Standard APS 221 Large Exposures* (APS 221) released in December 2017 • Introducing clear and consistent measurement requirements also enhances ADIs' prudential safety and APRA's supervision. • This option is likely to result in regulatory and compliance costs associated with updating and maintaining systems and processes to measure exposures according to the proposed requirements. • APRA expects the benefits of this option, in terms of prudential safety and consistency across ADIs would materially exceed the option's costs.	**Option 2** • Option 2 is considered both a balanced and preferred approach to reviewing the measurement of exposures to related entities. • The costs associated with implementing the proposal are not expected to outweigh the benefits in terms of prudential safety and consistency across APRA's prudential framework and ADIs.
Prudential limits on exposures to related entities	**Keep the existing limit framework** • This option results in no immediate compliance costs for ADIs. • Leaving the prudential limits at current levels may continue to expose ADIs to substantial financial contagion, particularly as limits have effectively increased over time as capital ratios have increased (refer to Chapter 3).	**Adopt limits as per the Basel Core Principles** • This option would set the prudential limit on aggregate exposures at 25% of Tier 1 Capital. • By limiting each ADI's exposure to their related entities, prudential safety and financial system would materially improve. • However, this option carries material regulatory impacts as the degree of exposures that an ADI can originate to its related entities would need to be substantially	**Adopt limits that recognise Australia specific needs** • Alternatively, as proposed in this paper, APRA could make adjustments to the prudential limits by balancing Australian circumstances with limits criteria in the Basel Core Principles. • Lower prudential limits on exposures to related entities would still be required, resulting in enhancements to prudential safety and financial system stability. • As there would be a lower reduction in the

	There are also indirect costs as a result of not aligning with the Basel Core Principles on the setting of limits on exposures to related entities.	reduced. A long transition period would be required. Larger ADIs in conglomerate groups, and their subsidiaries, would be most impacted by these changes as they would be required to restructure the funding of their subsidiaries.	prudential limits as compared to option 2, this should result in substantially less prudential impacts on ADIs and the underlying business of the subsidiaries.
Extended licensed entity (ELE) framework	**Keep the ELE framework** - No immediate compliance costs for ADIs. - However, making no change will sustain the existing complexity and opaqueness of the framework which hinders effective supervision. This also exposes ADIs to substantial resolution and contagion risks (refer to Chapter 4).	**Full removal of the ELE framework** - Prudential safety and financial system stability would be improved through simplifying ADIs' group structures; enhancing transparency of activities to APRA's supervision; and improving the ability of an ADI's banking group to be resolved. - However, this option carries material regulatory impacts that would require ADIs to substantially restructure the funding of subsidiaries that are included as part of their ELE. Compliance costs also relate to professional services that may be required to restructure conglomerate groups.	**Adjust the ELE-eligibility criteria** - This option results in adjustments to the ELE framework such as removing the eligibility of certain offshore subsidiaries from being included in an ELE. Domestic ELE subsidiaries would continue to be eligible and funding structures simplified (refer to Chapter 4.2). - Prudential safety and financial system stability would be improved through simplifying ADIs' group structures; enhancing transparency of activities to APRA's supervision; and improving the ability of an ADI's banking group to be resolved. - There would be a reduction in regulatory impacts and compliance costs as compared to option 2. - However, ADIs with a substantial number of ELE subsidiaries which hold or invest in offshore assets will still be materially impacted and would require a lengthy transition period.
Funds Management	**Continue to expect compliance with APS 120 (2006)** This option results in no immediate compliance costs for ADIs.	**Incorporate funds management requirements in APS 120 (2006) into APS 222** This option involves incorporating all the requirements in APS 120 (2006) into an attachment in APS 222.	**Materially simplify the funds management requirements in APS 120 (2006) into APS 222** This option simplifies the requirements in APS 120 (2006) and incorporates these into an attachment

	• ADIs would continue to be expected to satisfy *Prudential Standard APS 120 Funds Management and Securitisation (2006)* (APS 120 (2006)), in relation to funds management activities • However, the requirements in APS 120 (2006) are considered outdated and it is crucial that APRA modernises and streamlines its prudential framework.	• This streamlines the prudential framework by having all applicable prudential requirements in existing standards. • However, as many of the requirements in APS 120 (2006) are outdated and may no longer be applicable, this revision arguably imposes operational inefficiencies for ADIs and record keeping costs.	in APS 222 (refer to Chapter 7) • This further streamlines and modernises APRA's prudential framework and ensures that the requirements on funds management activities are fit for purpose and reflect Australian conditions. • APRA considers that aside from updating systems, policies and processes there should be no material costs for implementing this option.
Other matters (e.g. group badging, disclosures and internal policies on related-entity dealings)	**Keep current requirements** • This option results in no immediate compliance costs for ADIs. • There would be no change to requirements such as group badging, disclosures, internal policies on related-entity dealings, and notification requirements to APRA (refer to Chapter 6). • However, this option has implications to APRA such as a failure to modernise its prudential requirements and keep them fit for purpose. • ADIs may continue to be exposed to substantial prudential risks if these requirements are not updated.	**Prohibit group badging and enhance other requirements** • This option involves making comprehensive changes such as prohibiting group badging and imposing additional approval requirements. • This option results in materially improved prudential safety by reducing the potential for reputational contagion to flow from an ADI's group member to the ADI by way of sharing common logos. APRA's supervisory powers would also be substantially enhanced. • However, this option produces material administrative, marketing and compliance costs to change logos across a material number of entities.	**Allow group badging subject to some enhancements and added flexibility for other requirements** • This option makes adjustments to Option 2 by considering Australian conditions. For example, group badging would be allowed subject to stronger prudential requirements such as enhanced disclosures (refer to Chapter 5). ADIs would not be required to consult with APRA prior to certain transactions, but would be required to notify APRA instead (refer to Chapter 6). • Prudential safety is improved through stronger disclosure requirements and greater efficiency for ADIs is achieved through prior-notification requirements. • Enhanced requirements on internal policies on related entities should produce immaterial regulatory costs such as updating policies and processes, and administrative costs in terms of record keeping.

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