Prudential Standard APS 222

Associations with Related Entities

Objective and key requirements of this Prudential Standard

This Prudential Standard requires authorised deposit-taking institutions (ADIs) to give due consideration to the risks associated with the corporate group of which they are a member and to ensure they are not exposed to excessive risk as a result of their associations and dealings with related entities.

The ultimate responsibility for the comprehensive management of contagion and intra-group concentration risks rests with the Board of directors.

The key requirements of this Prudential Standard are that an ADI must:

- monitor, manage and control potential contagion risk between the ADI and other members of a conglomerate group of which the ADI is a part;
- meet minimum requirements with respect to dealings with related entities and certain related matters; and
- comply with prudential limits on intra-group exposures.

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Authority

1. This Prudential Standard is made under section 11AF of the *Banking Act 1959* (the **Banking Act**).

Application

2. This Prudential Standard applies to all authorised deposit-taking institutions (ADIs) except **purchased payment facility providers** (**PPF providers**), subject to paragraph 3.

3. A **foreign ADI** is subject only to the requirements in paragraphs 14 to 25 inclusive.

4. APRA may, in writing, approve an Extended Licensed Entity (ELE) in relation to an ADI. The ELE will comprise the ADI and each subsidiary of the ADI specified in the approval on a **Level 2** basis (refer to Attachment A).

Interpretation

5. Terms that are defined in *Prudential Standard APS 001 Definitions* (APS 001) appear in bold the first time they are used in this Prudential Standard.

Dealings with related entities

6. For the purposes of this Prudential Standard, all entities controlled (whether directly or indirectly) by:

   (a) an ADI (other than subsidiaries that form part of the ELE); or

   (b) the ultimate domestic parent of an ADI (including the parent entity itself)

   are a 'related entity' of an ADI. Consistent with the definition of a conglomerate group set out in APS 001, a 'related entity' excludes the foreign parent(s) of an ADI, the foreign parent's overseas-based subsidiaries and their directly owned non-ADI entities operating in Australia[1]. Where appropriate, APRA may deem that other entities (and their subsidiaries) are a 'related entity' of an ADI.

7. The **Board** of an ADI must establish, and monitor compliance with, policies governing all dealings with related entities. The policies, including any material changes thereto, must be provided to APRA if requested.

8. An ADI's Board policies on related-entity dealings must, at a minimum, include:

   (a) a requirement that the ADI address risks arising from dealings with related entities as strictly as it would address its risk exposures to unrelated entities (refer to paragraph 9);

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[1] Prudential limits on the aggregate exposure of an ADI to these entities are set out in *Prudential Standard APS 221 Large Exposures*.

(b) prudent limits on exposures to related entities at both an individual and aggregate level (refer to paragraph 11);

(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 (refer to paragraphs 21 to 24); 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.)

9. Terms or conditions imposed by an ADI in relation to its dealings with related entities that are inconsistent with the benchmark for unrelated entities must be approved by the Board of the ADI with justifications fully and clearly documented in a register. The ADI must make this register available for inspection by APRA if so requested.

10. An ADI must not:

(a) have 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

(b) agree to cross-default provisions whereby a default by a related entity on an obligation (whether financial or otherwise) triggers or is deemed to trigger a default by the ADI in its obligations.

11. The Board of an ADI must, in determining limits on acceptable levels of exposure to related entities, 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.

12. An ADI must satisfy APRA that it has adequate systems and controls to identify, review, monitor and manage exposures arising from dealings with related entities. APRA may require an ADI to establish additional internal controls and a more robust reporting mechanism and to maintain a higher **Prudential Capital Requirement** (**PCR**) if APRA is not satisfied with the adequacy of the ADI's systems and controls[2].

[2] Refer to *Prudential Standard APS 110 Capital Adequacy* for further details.

Provision of support

13. An ADI may provide support to related entities (and vice-versa) provided such support accords with the prudential requirements set out in paragraphs 7 to 12 in relation to the policies governing an ADI's dealings with related entities[3]. An ADI must not give the impression of ADI support unless there are formal legal arrangements in place providing for such support.

14. 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 must be able to demonstrate to APRA that the home supervisor is aware of the obligations and has no objection to the transaction.

Group badging[4]

15. 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 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 (refer to paragraph 17) to reduce the risk of giving 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.

16. 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.

17. To enable counterparties to clearly distinguish between dealings with an ADI and those with other non-ADI group entities, the ADI must 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:

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3 Paragraph 1313 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*).

4 All paragraphs under this section also apply to non-ADI entities operating in Australia directly owned by the foreign parent of an ADI or by the parent's subsidiaries.

(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 (refer to paragraphs 13 and 14). The nature and limit of such support should also be prominently disclosed where appropriate.

18. For group members involved in securitisation, prudential requirements in relation to disclosure and separation are set out in *Prudential Standard APS 120 Securitisation*.

Distribution of products[5]

19. Where an ADI distributes the financial products of other group members (or third parties), the ADI 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 (refer to paragraphs 13 and 14).

20. An ADI must ensure that, when other members of the group (or third parties) distribute its products in either an agent or representative capacity:

(a) appropriate disclosures are present detailing the respective roles of the ADI and the other group members or third parties (refer to paragraph 19); and

(b) the other group members (or third parties) do not, unless otherwise approved, in writing, by APRA (and supported by appropriate contractual arrangements – refer to paragraph 21), assume any key decision-making function of the ADI (e.g. in relation to creditworthiness) in distributing the ADI's products.

Participation in group operations[6]

21. 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

[5] Refer to footnote 4.
[6] Refer to footnote 4.

must satisfy the prudential requirements set out in *Prudential Standard CPS 231 Outsourcing*);

(b) such operations do not lead to any confusion in the mind of customers;

(c) these operations do not adversely affect the safety and soundness of the ADI as a stand-alone entity;

(d) the arrangements covering participation in group operations do not prevent APRA from being able to obtain information required for the supervision of an ADI or pertaining to the group as a whole; and

(e) there is 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.

22. 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.

23. An ADI must 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.

24. An ADI's participation in group operations must be approved by the Board. In approving such activities, the Board must:

(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.

25. The Board of an ADI must establish policies and procedures to address risks arising from the ADI's participation in group operations. The policies must be provided to APRA upon request and APRA must be informed of any material changes as soon as practicable. An ADI must address these risks on the same basis as it would if such operations were undertaken by unrelated entities.

Prudential limits on intra-group exposures

26. An ADI, or, where applicable, an ELE, must ensure that its exposures to related entities comply with the following limits[7]:

(a) related ADIs (including overseas based equivalents):

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[7] These limits are measured against an ADI's or ELE's Level 1 capital (calculated in accordance with *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*) as appropriate.

(i) exposure to individual related ADI – 50 per cent of the amount of **Regulatory Capital** (**Total Capital**) held by an ADI on a **Level 1** basis; and

(ii) aggregate exposure to all related ADIs – 150 per cent of the amount of Regulatory Capital held by an ADI on a Level 1 basis;

(b) other related entities:

(i) exposure to other individual regulated related entity (other than a related ADI or related overseas-based equivalent) – 25 per cent of the amount of Regulatory Capital held by an ADI on a Level 1 basis;

(ii) exposure to individual unregulated related entity – 15 per cent of the amount of Regulatory Capital held by an ADI on a Level 1 basis; and

(iii) aggregate exposure to all related entities (other than related ADIs and related overseas-based equivalents) – 35 per cent of the amount of Regulatory Capital held by an ADI on a Level 1 basis.

27. An ADI's (or ELE's) exposure to a related entity, for the purposes of paragraph 26, 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

(a) includes (but is not limited to):

(i) outstanding balances of all loans and advances;

(ii) all unused advised off-balance sheet commitments (refer to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112)), whether revocable or irrevocable;

(iii) the credit equivalent amounts of all market-related contracts (calculated in accordance with APS 112)[8]; and

(iv) in the case of a regulated related entity (i.e. any related entity directly regulated by APRA or by an equivalent banking or insurance prudential regulator overseas), equity exposure and capital support (excluding the intangible component of investments deducted from Common Equity Tier 1 Capital) provided to the related entity (including off-balance sheet exposure arising from any guarantee of a capital instrument issued by the related entity) that has not been deducted from the ADI's Level 1 capital for capital adequacy purposes;

[8] In determining an ADI's or ELE's exposure to a related entity, netting by novation and close-out netting are permissible for market-related contracts provided all the requirements for netting set out in APS 112 are met.

(b) excludes:

(i) exposures of the ADI to, including equity investments in, subsidiaries that form part of the ELE (refer to Attachment A);

(ii) exposures (including equity exposures and capital support) that have been deducted from the ADI's Level 1 capital for capital adequacy purposes (refer to APS 111);

(iii) exposures to the extent that they are secured by cash deposits (subject to satisfying the criteria set out in APS 112);

(iv) exposures to the extent that they are guaranteed by governments, or secured by government securities (subject to satisfying the conditions set out in APS 112);

(v) exposures arising in the course of settlement of market-related contracts; and

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

28. Notwithstanding paragraph 26, APRA may, in writing, set specific limits on an ADI's exposures to related ADIs, other related entities, a group of related ADIs or a group of related entities, on a case-by-case basis, having regard to the ADI's individual circumstances.

Approval requirements

29. An ADI must obtain prior written approval from APRA for any proposed exposures in excess of the prescribed limits set out in paragraph 26 or specific limit(s) imposed by APRA under paragraph 28. Such approval will only be granted on an exceptional basis. The ADI concerned must satisfy APRA as to why the proposed exposure(s) might reasonably be expected not to expose the ADI (or ELE) to excessive risk. APRA may impose a higher PCR on the ADI on a Level 1 basis to compensate for the additional risk that may be associated with the proposed exposure(s).

30. An ADI must obtain APRA's prior written approval for the establishment or acquisition of a regulated presence domestically or overseas.

Prior consultation requirements

31. An ADI must 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 20 per cent of equity interest in an entity; and

(c) taking up equity interest in an entity arising from the work-out of a problem exposure where:

(i) this exceeds 0.15 per cent of the ADI's Level 2 Regulatory Capital before deductions (calculated in accordance with APS 111); or

(ii) this will result in the ADI acquiring (whether directly or indirectly) more than 10 per cent of equity interest in the entity; or

(iii) this will result in the ADI's aggregate investment in non-subsidiary entities exceeding 5 per cent of the ADI's Level 2 Regulatory Capital before deductions (calculated in accordance with APS 111).

Notification requirements

32. An ADI must notify APRA, in accordance with section 62A of the Banking Act, of any material breach of the prudential limits on exposures to related entities prescribed in paragraph 26 or other specific limits imposed by APRA under paragraph 28, including remedial actions taken or planned to deal with the breach.

33. An ADI must report any equity investments that are not subject to the prior consultation requirements set out in paragraph 31, in writing, to APRA within three months of undertaking the investment.

34. An ADI must notify APRA 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.

Adjustments and exclusions

35. APRA may, by notice in writing, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to that ADI.[9]

[9] Refer to subsection 11AF(2) of the Act.

Attachment A

Extended Licensed Entity

1. APRA may, subject to the specific requirements set out in paragraph 3 of this Attachment, allow an ADI[10] to treat one or more of its subsidiaries, other than an entity regulated directly by APRA or by an equivalent regulator overseas, as part of the ADI itself for the purposes of measuring the ADI's capital adequacy and exposures to related entities. This requires APRA to use a 'substance over form' approach and to 'look through' the legal structure involved. Under this approach, an ADI and all its eligible subsidiary entities are 'consolidated' to form an ELE for measuring the ADI's capital adequacy and its exposures to all other related entities. Accordingly, the ADI's exposures to these subsidiaries, including equity investments, are exempted from the ADI's capital adequacy limits on equity and capital investments and intra-group exposure limits prescribed by APRA.

2. An ADI may apply to APRA to have one or more subsidiaries approved as part of its ELE. APRA will seek to identify, in consultation with the ADI, entities that are eligible for approval as part of the ELE. An ADI must inform APRA as soon as it becomes aware that a member of the ELE no longer meets the criteria set out in this Attachment. A subsidiary that no longer meets the criteria will cease to form part of the ELE.

3. APRA will, in deciding whether to approve a subsidiary of an ADI for inclusion within the ELE, have regard to the extent of the ADI's control over, and integration with, the subsidiary as well as the existence of any third-party liabilities of the subsidiary. Potential complications that might arise if underlying asset holdings have to be liquidated during financial stress will also be considered. The following criteria must be met in respect of the relationship between the ADI and the subsidiary:

   (a) the subsidiary is wholly owned by the ADI, and the Board of the subsidiary is composed entirely of members of the ADI's Board or senior management;

   (b) the ADI has complete information on the individual assets, liabilities and off-balance sheet positions of the subsidiary. The ADI must have access to the stand-alone accounting records of the subsidiary, and must be able to provide APRA with full and unfettered access to those records and any other information at any time, including during on-site visits;

   (c) the ADI has unrestricted control over the composition of the subsidiary's assets and liabilities. The ADI must demonstrate to APRA that there are no legal or regulatory barriers, including cross-border issues where the subsidiary is not incorporated or established in Australia, to the transfer of any assets or funds back to the ADI. There must be no legal obstacle to

[10] For the avoidance of doubt, a reference to an ADI in this Attachment means an ADI as defined in section 5 of the Banking Act, rather than an ELE.

the ADI instituting a wind-up of the subsidiary at any time and placing the remaining assets on the balance sheet of the ADI;

(d) the ADI manages the assets and liabilities of the subsidiary as part of its internal management practices. This includes reporting structures, accounting processes, audit arrangements and risk management and measurement systems. The ADI's risk management processes, management information systems and internal controls must be applied to the operations of the subsidiary. The senior management of the ADI must monitor the operations of the subsidiary to the same extent as the operations of the ADI itself. Systems for monitoring and control over the subsidiary must be included within the internal and external audit programs of the ADI;

(e) the subsidiary must not conduct any business that the ADI is prevented from conducting as part of its authority to undertake banking business;

(f) the ADI must not use the ELE to circumvent APRA's prudential requirements;

(g) where the subsidiary holds or invests in assets, other than claims on the ADI, the subsidiary must have no material liabilities (either on-balance sheet or off-balance sheet) to entities other than those that are part of the ELE. Tax liabilities and employee entitlements are exempt from this requirement; and

(h) where the subsidiary borrows on behalf of the ADI, all funds must be on-lent directly to the ADI.

4. The requirements in this Attachment are based on a simple arrangement involving an ADI and one or more directly owned subsidiary entities. This is not intended to preclude, for example, an arrangement in which an ADI invests in a single entity as a holding company and that entity in turn invests in multiple entities. In these circumstances, and provided the holding company is assessed by APRA as meeting the ELE criteria, APRA will 'look through' the holding company to determine whether individual entities meet all of the above criteria necessary to be included as part of an ELE. Entities that fail to meet these criteria will be excluded from the ELE.