Discussion Paper

Counterparty credit risk for ADIs

15 September 2016

www.apra.gov.au
Australian Prudential Regulation Authority

Preamble

This discussion paper outlines the Australian Prudential Regulation Authority's (APRA's) proposed revisions to its prudential framework for counterparty credit risk for authorised deposit-taking institutions. Proposed changes incorporate recent amendments to the Basel Committee on Banking Supervision's framework for counterparty credit risk.

Concurrently with this paper, APRA is releasing for public consultation a draft new prudential standard, *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk*, and draft revised *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*.

APRA invites written submissions on its proposals. APRA will be holding a two-month public consultation.

This discussion paper and the draft prudential standards are available on APRA's website at www.apra.gov.au. Written submissions should be sent to ADIpolicy@apra.gov.au by 11 November 2016 and addressed to:

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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.

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Glossary

Term	Meaning
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 112	*Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*
APS 180	*Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk*
Basel Committee	Basel Committee on Banking Supervision
Central counterparty	A clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer. A central counterparty becomes counterparty to trades with market participants through novation, an open offer system, or another legally binding arrangement. For the purposes of the capital framework, a central counterparty is a financial institution.[1]
Clearing member	A member of, or a direct participant in, a central counterparty that is entitled to enter into a transaction with the central counterparty.
Client of a clearing member	A party to a transaction with a central counterparty through either a clearing member acting as a financial intermediary, or a clearing member guaranteeing the performance of the client to the central counterparty.
Counterparty credit risk	The risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default.
Default funds	Clearing members' funded or unfunded contributions towards, or underwriting of, a central counterparty's mutualised loss-sharing arrangements.
G20	Group of Twenty - an international forum for the governments of 20 major economies.

1 'Financial institution' is defined in *Prudential Standard APS 001 Definitions*.

Term	Meaning
Initial margin	Collateral that is collected to cover the potential future exposure that could arise from future changes in the market value of a derivative transaction over the close-out period in the event of a counterparty default.
Long settlement transaction	A transaction where a counterparty undertakes to receive or deliver a security, a commodity, or a foreign exchange amount against cash, other financial instruments, or commodities at a contractually specified settlement or delivery date that is more than the lesser of (i) the market standard for the particular instrument and (ii) five business days after the date on which the parties enter into the transaction.
OTC derivative transaction	Over-the-counter derivative transaction - a customised, privately negotiated, risk-shifting agreement, the value of which is derived from the value of an underlying asset.
SA-CCR	Standardised approach for measuring counterparty credit risk exposures - the Basel Committee's new non-internal model approach for measuring counterparty credit risk associated with OTC derivatives, exchange-traded derivatives, and long settlement transactions.
SFTs	Securities financing transactions – are transactions such as repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions where the value of the transactions depends on the market valuation of securities and the transactions are typically subject to margin agreements.
Trade exposure	An exposure a clearing member or a client of a clearing member has to a central counterparty reflecting a measure of the current mark-to-market value (replacement cost) and the potential future exposure arising from OTC derivatives, exchange traded derivatives, long settlement transactions or securities financing transactions. The trade exposure is calculated on a bilateral basis, and must include the initial margin posted by an ADI, as well as any variation margin due to the ADI from the central counterparty that has not yet been received.
Variation margin	Collateral that is collected or paid to reflect the current mark-to-market exposure resulting from changes in the market value of a derivative transaction.

Executive summary

The Australian Prudential Regulation Authority (APRA) is proposing revisions to its prudential framework for counterparty credit risk for authorised deposit-taking institutions (ADIs) in order to reflect changes to the Basel Committee on Banking Supervision (Basel Committee)'s framework. Revisions are proposed to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) and a new prudential standard is proposed: *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180).

This paper outlines APRA's proposed implementation of the Basel Committee's *The standardised approach for measuring counterparty credit risk exposures* (March 2014) (SA-CCR) and *Capital requirements for bank exposures to central counterparties – final standard* (April 2014).

APRA's proposals seek to deliver improved risk sensitivity in the measurement of counterparty credit risk exposures while retaining an appropriate degree of simplicity in the framework. APRA proposes that all ADIs entering into an over-the-counter (OTC) derivative transaction, exchange traded derivative transaction, or long settlement transaction will be required to use the SA-CCR methodology to measure the counterparty credit risk exposure. APRA also proposes that all ADIs will be required to hold capital for exposures to central counterparties in a manner consistent with the Basel Committee's final standard. At this time, APRA does not propose introducing the Basel Committee's internal model method.

APRA's proposed implementation of the SA-CCR and requirements for exposures to central counterparties is broadly consistent with the Basel Committee's framework, with two adjustments for Australian conditions. The adjustments proposed are:

- an implementation date of 1 January 2018, as opposed to 1 January 2017, with the additional option for an ADI that meets certain criteria to apply for approval from APRA to further extend its implementation date for SA-CCR; and
- not incorporating specific capital treatment for multi-level client structures in the capital framework for exposures to central counterparties.

These adjustments are intended to mitigate the cost, resource burden and competitive impact of implementing the revised framework, particularly for smaller ADIs, as well as to avoid undue complexity within the framework.

APRA also proposes utilising this opportunity to make a number of minor amendments to existing requirements in APS 112. These proposed changes are outlined in a letter to ADIs released today.[2]

2 Refer to http://apra.gov.au/adi/Pages/September-2016-consultation-APS-112.aspx.

Chapter 1 — Introduction

1.1 Overview

Counterparty credit risk is the risk that an entity suffers a loss in the event that a counterparty to a market-related transaction defaults before the final settlement of the transaction's cash flows. For ADIs that enter into OTC derivative transactions, exchange traded derivative transactions, securities financing transactions (SFTs) or long settlement transactions, the capital requirement for counterparty credit risk forms an important component of the prudential capital requirements.

In 2014, the Basel Committee finalised revisions to its framework relating to the measurement of counterparty credit risk exposures and capital requirements for exposures to central counterparties.

The Basel Committee's *The standardised approach for measuring counterparty credit risk exposures* (March 2014)[3] introduced a new non-internal model method for measuring counterparty credit risk exposures (SA-CCR) that replaces the two existing non-model approaches in the Basel framework. Additionally, *Capital requirements for bank exposures to central counterparties – final standard* (April 2014)[4] replaces the Basel Committee's July 2012 interim standard on bank exposures to central counterparties.

APRA proposes to incorporate these revisions into its ADI prudential framework. APRA proposes to implement these changes through a new ADI prudential standard for counterparty credit risk, *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180). The implementation of these revisions in a new counterparty credit risk prudential standard also necessitates amendments to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112). APRA does not propose to introduce the Basel Committee's internal model method (IMM) into its prudential framework at this time.

The key difference between APRA's proposals and the Basel framework is in relation to the proposed timetable for implementation. APRA has proposed a delayed implementation date for these reforms. APRA also does not propose to incorporate the specific capital treatment for multi-level client structures for central clearing.

APRA anticipates that, following consideration of submissions received, it will release the final prudential standards in 2017.

1.2 Structure of this paper

This paper outlines proposed revisions to APRA's ADI prudential framework for counterparty credit risk. Chapter 2 sets out APRA's proposed implementation of the SA-CCR, while Chapter 3 outlines APRA's proposed capital requirements for exposures to central counterparties. Finally, Chapter 4 outlines proposed consequential amendments to other prudential standards resulting from the changes outlined in this discussion paper.

1.3 Balancing financial safety and other considerations

In proposing revisions to its ADI prudential framework for counterparty credit risk, APRA has sought to find an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, whilst promoting financial stability. On balance, APRA considers that proposals in this discussion paper will deliver improved prudential outcomes and provide efficiency and competitive benefits to ADIs.

In particular, the design of the SA-CCR addresses known deficiencies in existing methodologies for measuring exposure at default for counterparty

3 *The standardised approach for measuring counterparty credit risk exposures*, Basel Committee, March 2014.

4 *Capital requirements for bank exposures to central counterparties - final standard*, Basel Committee, April 2014.

credit risk exposures. Implementing the SA-CCR will strengthen prudential safety by improving risk sensitivity in the measurement of counterparty credit risk exposures.

Adopting the Basel Committee's final standard for bank exposures to central counterparties will assist in improving prudential safety outcomes by ensuring the capital requirements for ADIs' exposures to central counterparties are commensurate with the inherent risks of these exposures.

Further, adopting an implementation timetable with a later phase-in date for ADIs with immaterial counterparty credit risk exposure will reduce the competitive impact and regulatory burden of implementing the revised framework.

1.4 Request for views

APRA invites stakeholders to provide views on the impact of its proposals on considerations of efficiency, competition, contestability and competitive neutrality, while recognising APRA's prudential safety objectives.

In particular, APRA invites views on:

- its proposed application of the standardised approach for measuring counterparty credit risk exposures to all ADIs transacting in OTC derivative transactions, exchange traded derivative transactions, and long settlement transactions;
- the proposed initial implementation date of 1 January 2018, as opposed to the Basel Committee's implementation date of 1 January 2017;
- the proposal to allow an ADI with immaterial counterparty credit risk exposure to apply for approval to defer its implementation date for SA-CCR to 1 January 2019; and
- the proposal that all ADIs should transition to the SA-CCR methodology by 1 January 2019 without exception.

While APRA considers that implementation of the SA-CCR will improve financial safety outcomes, APRA notes that considerations of competition and efficiency may warrant the introduction of an alternative to the proposed approach for measuring counterparty credit risk exposures for ADIs with immaterial counterparty credit risk exposure. APRA invites views on the merits of considering the introduction of a simple and conservative alternative, such as the adoption of a modified current exposure method (CEM) or a flat rate capital add-on. If respondents see merit in a simplified alternative, APRA also invites views on any eligibility criteria for such a treatment.

1.5 Timetable

Given the time and resources required to implement the SA-CCR and final standard for bank exposures to central counterparties, APRA considers it appropriate to provide a reasonable implementation period following the release of APRA's final requirements, with the requirements coming into effect on 1 January 2018.

APRA also proposes to allow an ADI to apply for approval to further delay its implementation of SA-CCR until 1 January 2019. The extended transition time will be available, by application to APRA, for ADIs with non-material counterparty credit risk exposure. APRA will not consider an application to further postpone implementation of the SA-CCR from an ADI that is a direct clearing member of a central counterparty.

Approval of a delayed implementation date to 1 January 2019 is intended to reduce implementation costs for ADIs with a non-material level of activity in derivatives. A deferred implementation date of 1 January 2019 will provide an ADI with an extended period of time to implement SA-CCR following the release of APRA's final prudential standards.

APRA proposes that all ADIs with counterparty credit risk exposures implement the SA-CCR by 1 January 2019.

APRA invites views on these proposals including the requirement that all ADIs with counterparty credit risk exposure use the SA-CCR methodology to determine counterparty credit risk exposures.

1.6 Counterparty credit risk prudential standard

While making significant revisions to its framework for counterparty credit risk, APRA proposes establishing a dedicated ADI prudential standard for counterparty credit risk.

This restructuring is intended to improve clarity and useability, as well as to recognise the specific capital treatment required for counterparty credit risk exposures. APRA anticipates this approach will also be beneficial when considering future revisions to the ADI credit risk framework.

In the draft prudential standards released with this discussion paper, APRA proposes relocating APRA's existing counterparty credit risk requirements from APS 112 into the new counterparty credit risk prudential standard, APS 180. Until 1 January 2018, APRA's prudential requirements for counterparty credit risk will remain unchanged, but will move location. APRA proposes to move the existing counterparty credit risk requirements that are currently located in Attachment C of APS 112 to Attachment F of APS 180, and the existing calculation methodology for measuring counterparty credit risk exposure amounts, the CEM, from Attachments B and J of APS 112 to Attachment E of APS 180. The revised draft APS 112 released for consultation reflects these changes.

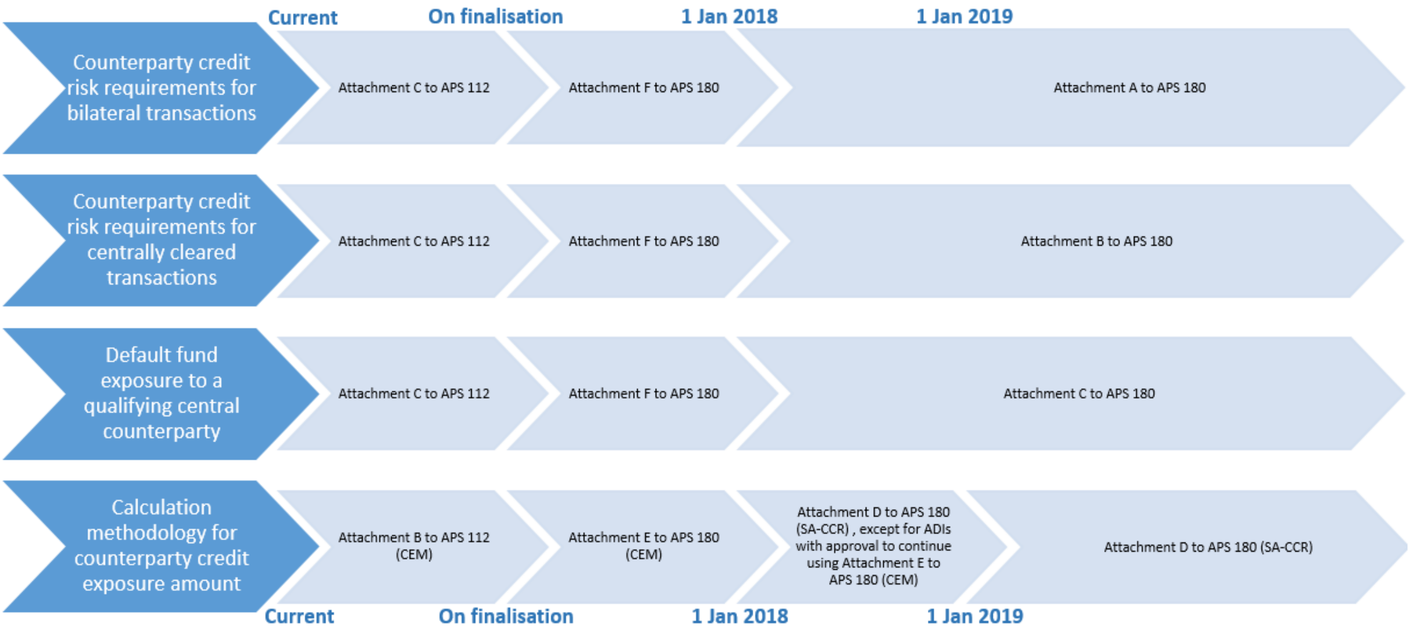
To maintain continuity of APRA's existing counterparty credit risk requirements, APRA proposes that revised APS 112 and Attachments E and F of APS 180 will take effect immediately on finalisation of this package.

From 1 January 2018, the new requirements relating to the SA-CCR and final standard for exposures to central counterparties will take effect. As such, from 1 January 2018, the requirements set out in Attachment F of APS 180 will cease to be effective, and will be replaced by the requirements for bilateral transactions, centrally cleared transactions, qualifying central counterparty default fund exposures and the SA-CCR methodology set out in Attachments A, B, C and D of APS 180, respectively.

Under Attachment E of APS 180, the CEM will continue to be effective from 1 January 2018 until 31 December 2018 for those ADIs with approval from APRA to continue using the CEM during this period. Finally, on 1 January 2019, Attachment E of APS 180 will cease to be effective.

The proposed transition process is summarised in Figure 1.

Figure 1 - Proposed phase-in of APS 180



1.7 Reporting framework and guidance

After finalising its prudential requirements for counterparty credit risk, APRA intends to consult on proposed amendments to its reporting framework related to counterparty credit risk exposures for ADIs.

APRA's proposed changes to the reporting framework will also reflect amendments resulting from the introduction of margin requirements for non-centrally cleared derivatives in *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives*.

APRA also intends to consult on amendments to its guidance materials reflecting changes to the requirements for counterparty credit risk.

1.8 Request for cost-benefit analysis information

APRA requests that all stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed changes 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 Regulatory Burden Measurement Tool 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/home.aspx.

Respondents are requested to 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 cost assessment to APRA, respondents are asked to 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.

Chapter 2 — Standardised approach for measuring counterparty credit risk exposures

2.1 Background

Basel II[5] provided three methods to measure counterparty credit risk exposures: the CEM, the standardised method (SM) and the IMM.

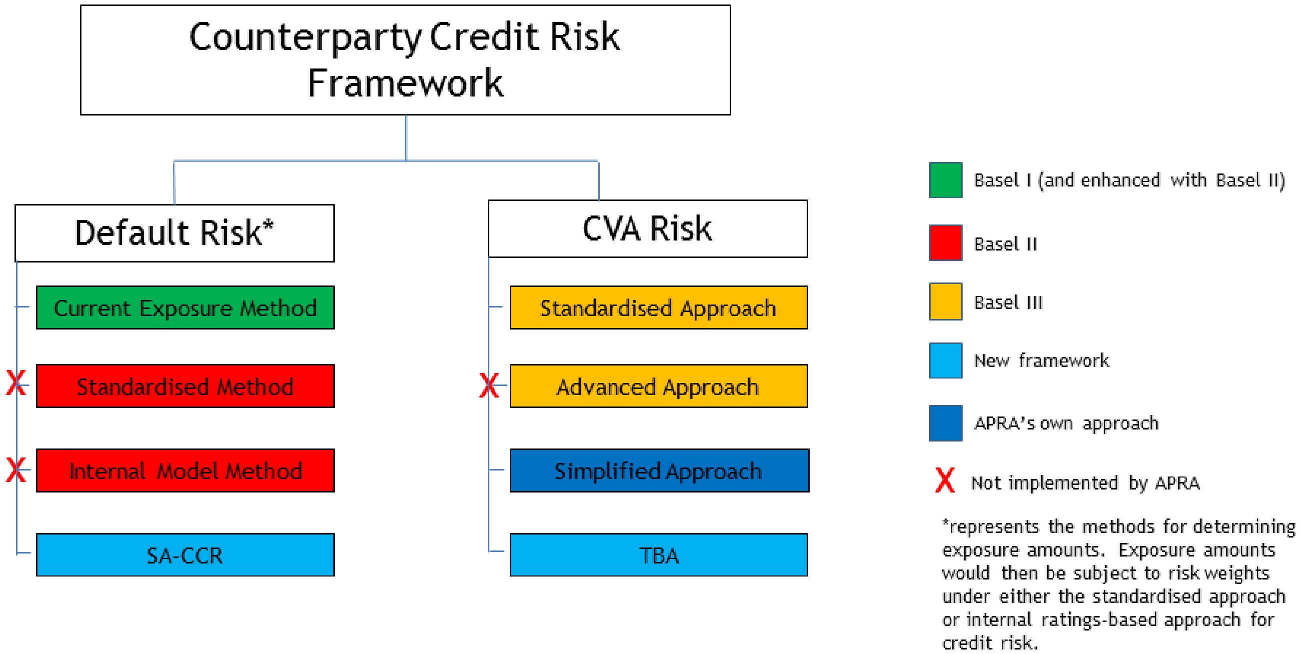
APRA's current framework requires all ADIs to utilise the CEM to calculate exposure at default for counterparty credit risk. APRA did not allow the SM or IMM methods when it implemented Basel II.

Since the introduction of Basel III,[6] the Basel framework accounts for two types of counterparty credit risk related losses for bilateral exposures: losses from counterparty default (determined via risk-weighted credit exposure for counterparty credit default risk) and also losses arising from credit valuation adjustment (CVA) increases (CVA risk capital charge).

APRA currently requires most ADIs to use the Basel III standardised CVA approach included in APS 112 to determine CVA risk capital charges. As an alternative to the standardised CVA approach, APRA allows an ADI to apply for approval to use a simplified approach to calculate the CVA risk capital requirement. APRA may permit an ADI to use the simplified approach where it is satisfied that the nature and scale of the ADI's derivatives activity is such that the resulting counterparty credit risk exposure is not material.

Figure 2 provides an overview of the history of the Basel framework for counterparty credit risk.

Figure 2 - History of the Basel Committee's counterparty credit risk framework



5 *Basel II: Revised international capital framework*, Basel Committee, June 2006.

6 *Basel III: A global regulatory framework for more resilient banks and banking systems*, Basel Committee, June 2011 (revised version).

2.1.1 Deficiencies in the existing framework

There are a number of known deficiencies in the existing non-modelled approaches – the CEM and SM - for measuring counterparty credit exposures in the Basel framework. In particular, the CEM has been criticised for the following limitations:

- the CEM framework does not differentiate between margined and unmargined counterparty credit risk exposures in its calculation of potential future exposure;
- the CEM's recognition of netting benefits is too simplistic and not reflective of economically meaningful relationships between derivative positions;
- the CEM formulation uses only two factors (the type of asset and the residual maturity) to estimate the exposure amount for different products. As a result, CEM is not granular enough to capture risks and correlations within asset classes; and
- the supervisory add-on factors in CEM are outdated and do not sufficiently capture the level of volatilities as observed over recent stress periods, including during the global financial crisis.

Although more risk-sensitive than the CEM, the SM was also criticised for a lack of differentiation between margined and unmargined transactions, as well as inconsistent implementation.

The criticisms of these existing approaches for calculating counterparty credit risk exposures led the Basel Committee to develop a single non-internal model method for measuring exposure at default for counterparty credit risk. The Basel Committee's main objectives in developing a single non-internal model approach were to formulate an approach that:

- applies to a wide variety of transaction types (margined, unmargined, centrally cleared, non-centrally cleared/bilateral);
- can be implemented simply and easily;
- minimises discretion used by national authorities and institutions; and
- improves the risk sensitivity of the capital framework without adding undue complexity.

2.2 The standardised approach for measuring counterparty credit risk exposures

In March 2014, the Basel Committee finalised its new standardised approach for measuring exposure at default for counterparty credit risk, the SA-CCR. The SA-CCR replaces both the CEM and the SM and addresses the deficiencies identified in these approaches.

The SA-CCR maintains the same general structure as the CEM, consisting of two key regulatory components: replacement cost and potential future exposure. As with CEM, the SA-CCR provides a methodology to calculate exposure at default, which is an input to the counterparty credit default risk capital requirement and the current CVA risk capital charge.

2.2.1 Benefits of SA-CCR

As the SA-CCR is designed to address the deficiencies identified in the CEM, APRA considers that there are significant benefits associated with implementing the SA-CCR. In particular, APRA considers the key benefits associated with implementation of the SA-CCR include:

Margining

Recognising that margining provides counterparty credit risk mitigation, the SA-CCR differentiates between margined and unmargined exposures in the calculation of both replacement cost and potential future exposure. This aspect of the SA-CCR is important, particularly as more derivative trades will become subject to margining requirements.

Netting and granularity

The SA-CCR permits more meaningful and granular recognition of netting benefits compared to the CEM.

Under the SA-CCR, an ADI must allocate all derivative contracts within a single netting set to one of five asset classes, and then further divide these into separate hedging sets. No recognition of offsetting or diversification benefits is permitted between asset classes or between hedging sets.

Within a single hedging set, transactions are further divided into categories. Partial offsetting of transactions is permitted across categories within a hedging set, while full offsetting is permitted within the same category and the same hedging set.

Required asset classes, hedging sets and categories, as well as the permissible offsetting of positions, are depicted in Figure 3 below.

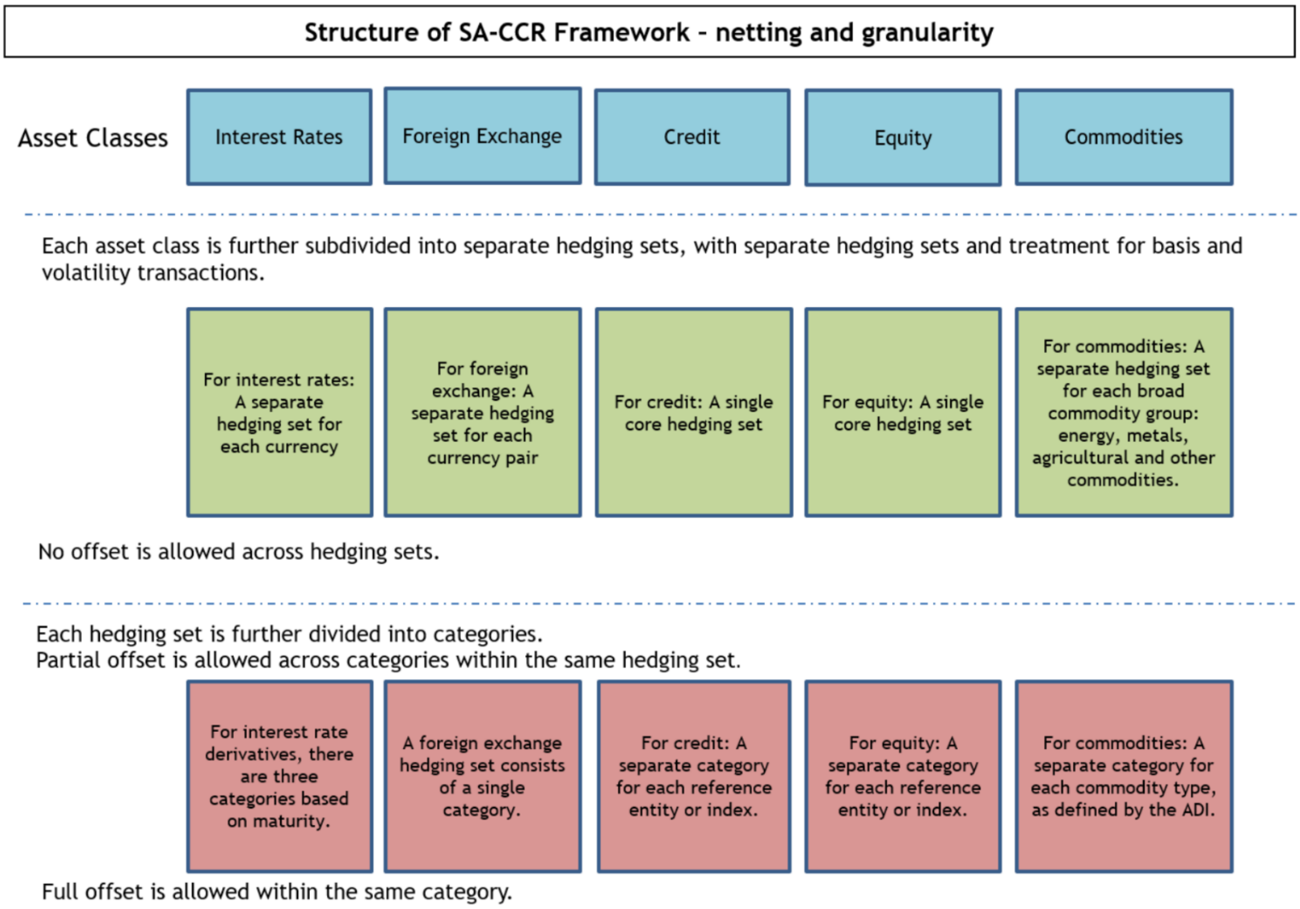
Volatility

A supervisory add-on factor reflecting volatility in the SA-CCR has been calibrated to reflect the level of volatilities observed in recent periods of stress, including during the global financial crisis. This replaces the CEM's outdated volatility add-on factor.

2.3 APRA's proposed implementation of SA-CCR

APRA proposes to incorporate the SA-CCR into its prudential framework in place of the CEM. As the SA-CCR is intended to be a standardised calculation across institutions and jurisdictions, the calculation methodology proposed in APS 180 is adopted as per the Basel framework.

Figure 3 - SA-CCR asset classes, hedging sets and permitted offsetting and diversification



2.3.1 Scope of application

SA-CCR applies to OTC derivative transactions, exchange traded derivative transactions and long-settlement transactions. It does not apply to SFTs.

APRA proposes to require all ADIs to use SA-CCR to measure their counterparty credit risk exposures arising from OTC derivative transactions, exchange traded derivative transactions and long-settlement transactions, consistent with the current scope of CEM.

APRA invites views on the proposed scope of application of SA-CCR to all ADIs.

2.3.2 Timetable

While APRA considers that there are significant benefits associated with implementing SA-CCR, APRA is conscious that there may be substantial resourcing considerations for some ADIs. APRA's proposed phased implementation timetable is discussed in section 1.5 *Timetable*.

APRA notes that the SA-CCR is the proposed methodology for use in several other parts of the Basel framework, including the leverage ratio and large exposures requirements. Consistent with the proposed extension of the implementation timeline for SA-CCR, APRA proposes that an ADI is not required to use the SA-CCR in place of the CEM in other areas of APRA's framework until the date it is required to use SA-CCR to calculate exposure at default for counterparty credit risk. This includes the use of the SA-CCR as the methodology for an input into the calculation of its capital requirement for exposures to central counterparties, as discussed in Chapter 3 *Capital requirements for exposures to central counterparties*.

APRA invites views on its proposed timetable.

2.4 Simplified CVA approach

APRA considers that the continued use of the simplified approach to calculating CVA may not be consistent with the increased risk sensitivity of the SA-CCR. Consequently, APRA is considering whether to continue to permit an ADI to use the simplified CVA approach after it has moved to SA-CCR.

As the Basel Committee is currently revising its CVA framework, APRA intends to review its current simplified CVA approach following the finalisation of the Basel Committee's new CVA framework. APRA invites views on the continued use of the simplified CVA approach by ADIs.

2.5 Internal model method (IMM)

In the Basel Committee's counterparty credit risk framework, the only alternative method to SA-CCR from 1 January 2017 will be the IMM.

When APRA implemented Basel II, APRA decided not to introduce IMM and APRA does not propose to introduce the IMM into its framework at this time.

Since APRA last finalised changes to its counterparty credit risk capital framework in November 2012, it has continued to assess ADIs' approaches to the management and measurement of counterparty credit risk. While a number of institutions have upgraded their counterparty credit risk models, APRA is not satisfied that the internal modelling approaches employed by ADIs in this area are sufficiently robust or mature for the purpose of calculating regulatory capital. Development in counterparty credit risk models has not mitigated APRA's concerns around the difficulties in modelling counterparty credit risk exposures and the variability in measures of exposure at default and risk weighted assets arising from different models.

In light of its recent study on the variability of risk weighted assets in counterparty credit risk models, the Basel Committee is currently considering whether it may narrow down certain modelling choices and/or harmonise supervisory practices to increase consistency in modelling outcomes across jurisdictions. APRA notes that this may result in changes to the international policy framework around IMM and CVA models.

APRA will continue to monitor developments in both modelling methods and the international policy framework, and may consider the adoption of IMM at a future date.

Chapter 3 — Capital requirements for exposures to central counterparties

3.1 Background

In the aftermath of the global financial crisis, the Group of Twenty (G20) sought to increase the resilience of OTC derivatives markets and institutions. In 2009, G20 Leaders committed to improve market efficiency and risk management by requiring all standardised OTC derivatives to be cleared through central counterparties.

Trading through central counterparties yields several benefits, including:

- reducing counterparty credit risk by netting exposures and payment obligations on a multilateral basis;
- facilitating more orderly and efficient dispute resolution through central counterparties' systems, rules and resources; and
- increasing market transparency by making information on activities and exposures available to regulators and the public.

The move towards increased central clearing prompted the Basel Committee to review its capital treatment of exposures to central counterparties. Under Basel I and Basel II, all exposures to central counterparties were effectively deemed to be free of any counterparty credit risk and so were not subject to any counterparty credit risk capital requirements. With the move towards increased central clearing, the Basel Committee reassessed this treatment in order to:

- better reflect the inherent risks of the various types of exposures to central counterparties, which may not necessarily warrant a zero capital requirement; and
- ensure there are incentives to centrally clear OTC derivative transactions. To this end, capital requirements for bilateral transactions should be higher than for transactions cleared through central counterparties.

In July 2012, the Basel Committee released an interim framework for capital requirements for bank exposures to central counterparties. APRA implemented the Basel Committee's interim framework in 2013.

Since the release of its interim standard, the Basel Committee has undertaken additional work to improve its framework and address several known deficiencies in the interim standard, including:

- instances of insufficient capital being held against exposures to some central counterparties;
- instances of capital charges for exposures to central counterparties being higher than for bilateral transactions; and
- capital treatment penalising the maintenance of substantial default funds.

3.2 Basel Committee's final standard

In April 2014, the Basel Committee issued its final standard on capital requirements for bank exposures to central counterparties.

The final standard for bank exposures to central counterparties retains many of the features of the July 2012 interim framework, including the scope of application, treatment of trade exposures to qualifying central counterparties and the capital requirements for bank exposures to non-qualifying central counterparties.

The substantive changes from the interim framework are:

- a new approach for determining the capital requirements for default fund exposures to qualifying central counterparties;

- an explicit cap on capital charges applied to bank exposures to qualifying central counterparties so those charges cannot exceed the charges that would be applied if the central counterparty were a non-qualifying central counterparty;
- specifying the treatment of multi-level client structures; and
- employing the SA-CCR (as opposed to the CEM) in the calculation of an ADI's trade exposure and the hypothetical capital requirement of a central counterparty.

3.3 APRA's proposed implementation of the Basel Committee's final standard

APRA proposes to adopt capital requirements for ADI exposures to central counterparties that are broadly consistent with the Basel Committee's final standard.

3.3.1 Scope of application

APRA proposes to apply the Basel Committee's final framework for exposures to central counterparties to all locally-incorporated ADIs that have exposures to central counterparties. The proposed framework will apply to exposures to central counterparties arising from OTC derivative transactions, exchange traded derivative transactions, SFTs and long settlement transactions.

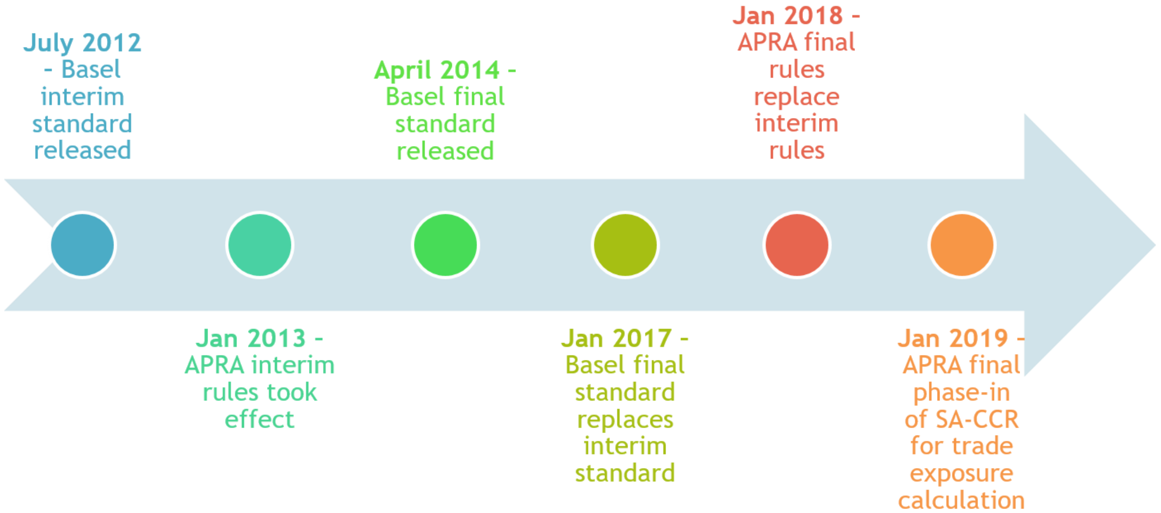
3.3.2 Timetable

As discussed in section 1.5 *Timetable*, APRA proposes that its revised capital requirements for ADI exposures to central counterparties take effect on 1 January 2018.

In line with APRA's proposal to permit an ADI to delay its implementation of SA-CCR until 1 January 2019 with prior approval, APRA proposes that an ADI may continue to use the CEM within the framework for calculating trade exposures to central counterparties until the date at which it is required to use SA-CCR to calculate exposure at default for counterparty credit risk exposures. That is, where an ADI receives approval to delay implementation of SA-CCR until 1 January 2019, it may utilise the CEM with the final capital requirements for ADI exposures to central counterparties from 1 January 2018 to 31 December 2018.

APRA invites views on its proposed timetable.

Figure 4 - Timeline of capital framework for exposures to central counterparties



3.4 Multi-level client structure

A multi-level client structure for central clearing is one in which an institution can centrally clear as an indirect client to a clearing member via another client of the clearing member. That is, when clearing services are provided to the institution by another institution which is not a direct clearing member, but is itself a client of a clearing member. This introduces a concept of multiple levels of clients. This structure gives rise to a 'higher level client' (the client providing clearing services) and a 'lower level client' (the institution clearing through that higher level client).

The Basel Committee's interim framework for bank exposures to central counterparties, on which APRA's existing framework is based, does not include specific treatment for multi-level client structures. The Basel Committee's final capital framework for exposures to central counterparties addresses this by specifying how an institution that is the higher level client and an institution that is the lower level client in a multi-level client structure must capitalise the transaction.

APRA understands that multi-level client structures are not widely used by ADIs in Australia and therefore proposes not to incorporate the treatment of multi-level client structures into its framework to avoid undue complexity. APRA invites submissions from any ADI that currently uses or intends to use a multi-level client structure. APRA will consider the need to include treatment of multi-level client structures in APS 180 based on industry feedback.

Chapter 4 — Consequential amendments to other prudential standards

APRA is taking the opportunity in this discussion paper to propose other amendments to prudential standards to support the implementation of APS 180 and the SA-CCR methodology and the removal of counterparty credit risk requirements from APS 112.

Changes will be made to prudential standards to update any cross-references as necessary and to incorporate new terminology flowing from APRA's proposals. APRA intends to make these changes as the relevant prudential standards are reviewed.

The main changes include:

- paragraphs 2 and 4 of Attachment A, and paragraph 2(a)(i) of Attachment C of *Prudential Standard APS 110 Capital Adequacy* (APS 110), to include the counterparty credit risk requirements calculated in accordance with APS 180 in the lists of credit risk exposures, total risk-weighted assets and private sector credit exposures, respectively;
- paragraphs 9 and 20 of Attachment D and footnotes 12 and 22 of APS 110, to update specific paragraph cross-references to Attachment J of APS 112;
- paragraph 10 of Attachment D of APS 110, to update the reference to Attachment B of APS 112;
- footnotes 9, 13, and 15 of APS 110, to update cross-references to the definitions of 'QCCP' and 'clearing member', respectively;
- paragraph 32(a) and footnote 26 of *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*, to reflect that total credit risk-weighted on-balance sheet assets and off-balance sheet exposures must also be determined in accordance with APS 180;
- paragraph 32 of Attachment B, and footnote 13 and paragraph 13 of Attachment C of *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113), to update references to APS 112 and credit equivalent amounts to reflect the introduction of APS 180 and the SA-CCR methodology;
- paragraphs 7 and 72 of Attachment B, paragraph 31 of Attachment C, and paragraph 4 of Attachment E of APS 113, to update specific paragraph cross-references to Attachment H of APS 112;
- paragraph 7 of *Prudential Standard APS 116 Capital Adequacy: Market Risk*, to indicate that counterparty credit risk requirements must be determined in accordance with APS 180; and
- paragraph 13(a)(iv) of *Prudential Standard APS 221 Large Exposures*, and paragraph 27(a)(iii) of *Prudential Standard APS 222 Associations with Related Entities*, to update references to credit equivalent amounts and APS 112 to reflect the introduction of the SA-CCR methodology and APS 180.

Changes will also be necessary for Prudential Standards currently in draft. These changes will include:

- paragraphs 30, 32, 37, 60, and 61, and footnotes 20 and 21 of draft *Prudential Standard APS 120 Securitisation* (draft APS 120),[7] to include APS 180 in the list of

7 Refer to http://www.apra.gov.au/adi/PrudentialFramework/Pages/Revisions-to-the-Securitisation-Framework.aspx.

prudential standards under which regulatory capital for credit risk must be calculated; and

- paragraph 41(b) of draft APS 120, to indicate that the exposure measurement methodology for derivatives is now contained in APS 180 rather than APS 112.

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