DISCUSSION PAPER

Revisions to Large Exposures

April 2017

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Preamble

The Australian Prudential Regulation Authority (APRA) is issuing this discussion paper to outline proposed revisions to the prudential framework for authorised deposit-taking institution (ADI) large exposures. The proposed changes to *Prudential Standard APS 221 Large Exposures* (APS 221) reflect the Basel Committee on Banking Supervision's (Basel Committee) *Standards: Supervisory framework for measuring and controlling large* exposures, released in April 2014.

Concurrently with this paper APRA is releasing for consultation draft revisions to:

- APS 221; and
- *Reporting Standard ARS 221.0 Large Exposures* (ARS 221.0), including:
  - *Reporting Form ARF 221.0 Large Exposures* (ARF 221.0);
  - *Reporting Form ARF 221.1 Large Exposures – Foreign ADI* (ARF 221.1);
  - the instruction guide for ARF 221.0; and
  - the instruction guide for ARF 221.1.

APRA invites written submissions on its proposals.

This discussion paper and the revised APS 221, ARS 221.0, ARF 221.0, ARF 221.1 and the instruction guides for ARF 221.0 and ARF 221.1 are available on APRA's website at: http://www.apra.gov.au.

Written submissions should be sent to ADIpolicy@apra.gov.au by 5 July 2017 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.

Executive summary

The Australian Prudential Regulation Authority (APRA) is proposing revisions to its prudential requirements for authorised deposit-taking institutions (ADIs) to reflect the internationally agreed framework for the management of large exposures. Revisions are proposed to Prudential Standard APS 221 Large Exposures (APS 221), Reporting Standard ARS 221.0 Large Exposures (ARS 221.0), Reporting Form ARF 221.0 Large Exposures (ARF 221.0), Reporting Form ARF 221.1 Large Exposures – Foreign ADI (ARF 221.1), and the instruction guides for ARF 221.0 and ARF 221.1.

APRA's existing requirements for managing large exposure risks and other credit risk concentrations are a long-standing and important component of APRA's prudential framework for ADIs. These requirements have not been materially updated since 2003 and a review is timely.

In 2014, the Basel Committee on Banking Supervision (Basel Committee) issued Standards: Supervisory framework for measuring and controlling large exposures (April 2014) (Basel large exposures framework). The large exposure requirements complement risk-based capital requirements and operate to measure and limit large exposures in relation to a bank's capital. The key aspects of the large exposure framework are:

- a limit of 25 per cent of Tier 1 Capital for an ADI's large exposures to a counterparty or a group of connected counterparties, with national discretion to impose smaller limits for certain types of exposures;
- criteria for identifying a group of connected counterparties; and
- clear and consistent measurement of large exposure values, including specific treatments to be applied for credit risk mitigation, trading book positions, covered bonds, structured vehicles, non-qualifying central counterparties and clearing activities.

APRA is proposing to update its existing large exposure framework to align with the Basel large exposures framework, with several adjustments. These adjustments include:

- a large exposure limit of 15 per cent of Tier 1 Capital for an ADI's exposures to a bank designated as a global systemically important bank (G-SIB);
- a large exposure limit of 15 per cent of Tier 1 Capital for exposures between banks designated by APRA as domestic systemically important banks (D-SIBs);
- a large exposure limit of 50 per cent of Tier 1 Capital for exposures to certain foreign governments;
- maintaining the current Australian approach for measuring off-balance sheet commitments; and
- not adopting the Basel Committee's concessionary recognition of covered bond exposure values.

APRA's proposals aim to strengthen the supervisory framework for large exposures, reduce system-wide contagion risk and strengthen the oversight of exposures that arise for an ADI from underlying assets within investment structures. These changes should also mitigate the risk of contagion between systemically important financial institutions, whose material losses are more likely to cause systemic consequences and impact financial stability in the event of a crisis.

The large exposure proposals will affect all ADIs to varying degrees, except foreign ADIs and purchased payment providers which will continue to be exempt. The impact of the proposed large exposure changes for each ADI will depend on, amongst other factors, the size of an ADI's capital, whether the ADI has been determined by APRA to be a D-SIB, whether an ADI has exposures to banks designated as G-SIBs, the nature of an ADI's relationships to connected counterparties, and differences in how an ADI currently measures its large exposures compared with the proposed methodology. APRA encourages ADIs to consider the proposals to amend its existing large exposures framework to understand the impacts that may occur.

Timetable

APRA intends to finalise its large exposures framework for commencement on 1 January 2019 in line with the Basel Committee's timeframes. APRA proposes to facilitate a period of best endeavours reporting for a period of six months prior to implementation.

Key changes to large exposure requirements

Current Large Exposure requirements	Proposed Large Exposure requirements
The definition of a large exposure is based on Regulatory Capital (i.e. Total Capital).	The definition of a large exposure is based on Tier 1 Capital.
Specific exclusions from large exposures include: exposures guaranteed by, or secured against securities issued by governments or central banks (with a 0% risk weight under APS 112), and exposures arising in the course of settlement of market-related contracts.	Specific exclusions from large exposures include: exposures to the Australian Government or Australian dollar exposures to the Reserve Bank of Australia, exposures to governments or central banks held for the Liquidity Coverage Ratio (LCR), intra-day interbank exposures, exposures to qualifying central counterparties relating to clearing activities, and exposures to lenders mortgage insurance from insured mortgages.
Related counterparties are broadly defined.	Connected counterparties are defined based on specific control and economic interdependence criteria; terminology has changed from related to connected counterparties.
The aggregate exposure to a counterparty or a group of related counterparties is limited to 25% of Regulatory Capital for external parties (other than governments, central banks and ADIs or equivalent overseas deposit-taking institutions) unrelated to the ADI, with the exception of: - a limit of 50% of Regulatory Capital for unrelated ADIs and their subsidiaries, with the aggregate exposure to non-deposit-taking subsidiaries capped at 25% of Regulatory Capital; and - a limit of 50% of Regulatory Capital for foreign parents and their subsidiaries; with the aggregate exposure to non-deposit-taking subsidiaries capped at 25% of Regulatory Capital.	The aggregate exposure to a counterparty or a group of connected counterparties is limited to 25% of Tier 1 Capital, with some exceptions: - 50% of Tier 1 Capital for exposures to foreign governments and central banks that receive a 0% risk weight in APS 112 (except for those held for the LCR); - 15% of Tier 1 Capital for exposures between banks designated by APRA as D-SIBs; and - 15% of Tier 1 Capital for all ADIs' exposures to banks designated as G-SIBs.
The measurement of exposure values is not specified.	The measurement of exposure values is specified for credit risk mitigation, trading book positions, covered bonds, non-qualifying central counterparties and clearing activity exposures, and structured vehicles.
Reporting covers the largest 10 exposures and all large exposures.	Reporting covers the largest 20 exposures and all large exposures (with and without credit risk mitigation), and separate reporting for certain excluded exposures.

Chapter 1 – Introduction

1.1 Background

APRA's large exposure requirements for ADIs, set out in APS 221, are an important part of the prudential framework and complement other risk management requirements within the prudential framework, as well as the risk-based capital framework. A key underlying purpose of large exposure requirements is to limit the emergence of large losses in the event of a counterparty failure, and to ensure that ADIs manage risks from concentration and contagion risks. APS 221 was last materially updated in 2003.

Over the course of the global financial crisis, and in subsequent years, it became evident that banks have not consistently measured, aggregated or controlled exposures to individual counterparties or to groups of connected counterparties. In particular, the variation existing amongst jurisdictions regarding measures of exposure, measures of capital and quantitative limits supported the need for the Basel Committee to review the large exposures framework to facilitate consistent large exposure standards and to ensure banks manage and limit excessive concentration risk.

In April 2014, the Basel Committee released its revised large exposures framework, *Standards: Supervisory framework for measuring and controlling large exposures* (Basel large exposures framework), which replaces the Basel Committee's large exposures guidance on monitoring and controlling large credit exposures released in January 1991.

APRA proposes to incorporate these revisions into its ADI prudential framework through implementing these changes in *Prudential Standard APS 221 Large Exposures* (APS 221) with several adjustments for Australia and for systemic exposures by applying national discretion encouraged by the Basel Committee.

1.2 Proposed revisions to APS 221

The proposed revisions to APS 221 aim to strengthen ADIs' approach to concentration risk management, which forms part of an ADI's risk management framework in line with *Prudential Standard CPS 220 Risk Management* (CPS 220), to identify and appropriately limit excessive concentration risks. The proposed large exposure requirements include requirements for ADIs to have risk concentration policies and processes within ADIs' risk management frameworks, and to ensure that concentration risk management is commensurate with an ADI's risk appetite, risk profile, capital and balance sheet size.

The proposed changes include revisions to the level of capital used in the definition of large exposures, the exposures excluded from large exposures, requirements to form a group of connected counterparties, and large exposure limits, including introducing limits involving systemically important banks to recognise the heightened contagion risks and potential for increased financial instability they introduce.

APRA's proposed large exposures framework specifies a clear and transparent approach to identifying and measuring large exposures which strengthens the ability to consistently compare large exposures across the industry and between jurisdictions.

APRA proposes that additional data be collected for large exposure reporting requirements to facilitate monitoring and controlling concentrations risks.

Prudential limits and other requirements for an ADI's exposures to other related entities are contained in *Prudential Standard APS 222 Associations with Related Entities*, which APRA intends to amend in due course as a consequence of changes to the large exposure requirements and to incorporate other prudential matters.

1.3 Structure of this paper

Chapter 2 sets out the definition of large exposures, the scope and coverage of the large exposure proposals, and requirements for identifying connected counterparties for large exposure purposes.

Chapter 3 provides details of large exposure limits, including the revised level of capital for large exposure purposes and specific quantitative large exposure limits.

Chapter 4 provides details for the measurement of large exposure values, including the treatment to be used for specific exposure values.

Chapter 5 sets out details regarding prior consultation, approval and notification requirements.

Chapter 6 sets out the proposed reporting requirements relating to large exposures.

1.4 Timetable

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

The Basel Committee will be implementing the Basel large exposures framework from 1 January 2019. APRA proposes to align with the Basel Committee's timeframes for implementation.

Reporting standards, reporting forms and instructions accompany this consultation package. APRA intends to facilitate a period of best endeavours reporting for a period of six months prior to implementation.

1.5 Balancing financial safety and other considerations

In proposing revisions to its ADI prudential framework for large exposures, 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 greater financial safety and financial system stability.

PRIMARY OBJECTIVES	
Financial safety ⬆	Financial system stability ⬆
Tighter limits will reduce excessive concentration risks, limiting large losses when a counterparty defaults. Clearer and more prudent measurement of exposures, such as to structured vehicles, increases transparency and ensures concentration risk is attributed to exposures appropriately. Financial safety is supported by improved information and transparency on large exposures through enhanced reporting requirements.	Financial system stability is expected to be improved through stronger management of concentration risk, for example through tighter limits, using a higher level of capital, connected counterparty requirements, and specified measurement of large exposures. There would be reduced risk of system-wide contagion risk through tighter limits on exposures between D-SIBs and to G-SIBs; this reduces the potential for material losses in a systemically important bank to generate concerns for the viability of their direct counterparties or connected counterparties, which encourages greater system stability.

OTHER CONSIDERATIONS	
Efficiency ⟷	Clear and transparent exposure measurement requirements, enabling ADIs to appropriately attribute risk to exposures. Efficiency may be reduced to the extent that tighter large exposure limits affect ADIs' ability to take on certain exposures.
Competition ⟷	Greater comparability of large exposures from applying a consistent measurement approach provides a more transparent and even playing field. Introducing tighter limits for systemically important banks limits concentration risk and may support competition amongst other ADIs in Australia. Consistency of the large exposure framework with international standards helps Australia maintain its reputation for international good practice.
Contestability ⟷	No material impact on contestability.
Competitive Neutrality ⬇	Competitive neutrality is impacted due to the introduction of differential large exposure limits. D-SIBs and ADIs with exposures to G-SIBs may be impacted due to tighter limits involving systemically important banks.

APRA has considered adjustments to the Basel large exposures framework to tailor requirements for the Australian financial system, while introducing a framework that is robust and internationally comparable, and which maintains Australian ADIs' market competitiveness both locally and internationally.

APRA is seeking views on the impact the proposals may have, particularly on the application of the proposals to ADIs to ensure a robust prudential framework that appropriately balances the objectives.

1.6 Request for cost-benefit analysis information

APRA requests that all interested 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 increases or decreases to the compliance costs incurred by businesses as a result of APRA's proposal.

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 that 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 regardless of regulatory requirements in their ordinary course of business.

Chapter 2 – Identifying large exposures

Broadly, large exposures exist when the aggregate exposures to a counterparty, or group of connected counterparties, are large relative to the capital of an ADI. This creates additional risks for ADIs compared with smaller, diversified exposures, due to the potential impact to the ADI if a counterparty defaults.

2.1 Definition of a large exposure

APRA proposes to update its definition of a large exposure to align with the definition in the Basel large exposures framework. A large exposure is proposed to be defined as:

Large exposure: an exposure to an individual counterparty, or a group of connected counterparties, which is greater than, or equal to, 10 per cent of an ADI's Tier 1 Capital.

The key differences between this definition and the current APS 221 definition of a large exposure are:

- Tier 1 Capital replaces Regulatory Capital (i.e. Total Capital);
- exposures to groups of 'connected' counterparties (refer to section 2.3) replaces 'related' counterparties; and
- the exposure values which are subject to the 10 per cent limit have been specified in more detail (refer to Chapter 4).

APRA is proposing to replace Regulatory Capital with Tier 1 Capital as this better aligns with the key principle in the Basel large exposures framework that the capital utilised can absorb unexpected losses on a 'going-concern' basis. As a consequence, Tier 1 Capital is considered as more appropriate than Total Capital in large exposure limits. As Tier 1 Capital is generally 85-100 per cent of Total Regulatory Capital, this will result in a small reduction of large exposure limit capacity for most ADIs.

2.2 Scope and coverage of large exposure requirements

Application at Level 1 and Level 2

APRA proposes to maintain its current approach, which aligns with the Basel large exposures framework, and apply the large exposure requirements at both Level 1 and Level 2 to all ADIs, excluding purchased payment facility providers and foreign ADIs. APRA proposes to maintain its current requirement that foreign ADIs must detail their large exposure and risk concentration policies and relevant controls in their Risk Management Strategy.

Risk concentrations

The Basel large exposures framework applies to risks from losses arising due to the default of an individual counterparty or a group of connected counterparties. Other forms of concentration risk are excluded from the Basel large exposures framework.

APRA intends to maintain its current approach that requires an ADI to consider a broad range of risk concentrations which may arise from particular counterparties, industries, countries and asset classes. This includes requirements that an ADI determine internal exposure limits for risk concentrations as part of its large exposures and risk concentrations policy and consider how these types of exposures are incorporated into its risk management framework in line with the ADI's risk appetite, risk profile, capital and size.

Excluded exposures

The Basel large exposures framework excludes certain exposures. APRA proposes to implement similar exclusions, including:

- exposures deducted from an ADI's Regulatory Capital under *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111);
- intra-day interbank exposures; and
- exposures to qualifying central counterparties (QCCPs) (as defined in paragraph 9 of APS 112) that relate to clearing activities.

In addition, APRA proposes to exclude:

- exposures to the extent that they have been written off;
- exposures to the Australian Government or any Australian dollar exposure to the Reserve Bank of Australia (RBA);
- exposures to governments or central banks which are held for Liquidity Coverage Ratio (LCR) purposes; and
- exposures to lenders mortgage insurers arising from the purchase of lenders mortgage insurance.

The Basel large exposures framework excludes sovereign exposures. APRA proposes to remove its current exclusion for exposures to governments or central banks which receive a zero per cent risk-weight under Attachment A of APS 112. Such exposures would be subject to a specified limit, with the exception of exposures that are held for LCR purposes (refer to Chapter 3).

Currently, indirect exposures arising from the purchase by ADIs of lenders mortgage insurance are not treated consistently across ADIs for purposes of large exposure measurement. APRA proposes to explicitly exclude exposures to lenders mortgage insurers arising from insured mortgages to ensure a consistent treatment is applied by all ADIs. This recognises that lenders mortgage insurance is typically not treated in practice as credit risk mitigation under APS 112 as well as *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113), but is instead recognised through the risk-weighting schedule for residential mortgages set out in Attachment D of APS 112.

Under the Basel large exposures framework, where an exposure that has been excluded is hedged by a credit derivative, an ADI must recognise an exposure to the counterparty providing the credit protection, despite the original exposure being exempted. APRA intends to implement this treatment.

2.3 Identifying groups of connected counterparties

The Basel large exposures framework introduces the concept of connected counterparties which are counterparties that share specific dependencies or relationships where it is likely that the default of one counterparty is likely to result in the default of another counterparty or counterparties. Such a group of connected counterparties can be seen to act as if they constitute a single risk similar to that of an individual counterparty and, under the Basel large exposures framework, are treated as a single counterparty.

APRA proposes to adopt the definition of connected counterparties in the Basel large exposures framework whereby, at a minimum, an ADI must identify groups of counterparties which are connected by a control relationship or an economic interdependence relationship. ADIs may also identify further reasons which connect counterparties to form a group of connected counterparties.

Control relationships

Counterparties are connected through a control relationship when one counterparty directly, or indirectly, has control over another counterparty. APRA proposes to adopt the definition in the Basel large exposures framework of when a control relationship exists (see paragraphs 22 and 23 of draft APS 221).

Economic interdependence relationships

Economic interdependence exists when the financial soundness of one counterparty may affect the financial soundness of another counterparty. APRA proposes to adopt the definition in the Basel large exposures framework of when an economic interdependence relationship exists (see paragraph 24 of draft APS 221).

The Basel large exposures framework requires that economic interdependence relationships be identified for an individual counterparty where the sum of the ADI's exposures to the individual counterparty exceeds five per cent of the ADI's Tier 1 Capital. APRA proposes to adopt this threshold to reduce the burden of identifying non-material economic interdependence relationships.

Exclusions

ADIs will not need to consider exposures to central counterparties (CCPs) (both QCCPs and non-qualifying CCPs) that relate to clearing activities in determining connected counterparties.

While an ADI must continue to identify and connect government-related entities which have control and economic interdependence relationships with other counterparties, the government or central bank itself is not to be treated as part of the group of connected counterparties; rather it is treated as a separate counterparty subject to large exposure limits (refer to Chapter 3). APRA proposes that governments and central banks be excluded in determining connected counterparties, as the risk arising from a bank's exposures to governments or central banks is not necessarily the same as that arising from exposures to government-related entities e.g. a government may use its discretion to support a certain state-owned enterprise, but not support another state-owned enterprise during a crisis.

Requests for exemptions

Where an ADI is of the view that certain counterparties should be exempt from being treated as a group of connected counterparties, the ADI can make a request to APRA for an exemption. APRA will consider the governance safeguards in place and specific circumstances which result in the ADI's exemption request, including how the ADI addresses aspects of the specific control or economic interdependence criteria through other means.

Chapter 3 – Large exposure limits

APRA proposes to implement the Basel large exposure limits, with certain exceptions as discussed below. APRA also proposes to adopt limits for an ADI's exposures to a bank designated as a G-SIB and for exposures of one Australian D-SIB to another Australian D-SIB.

3.1 Large exposure limits

Changes to existing limits

In line with the Basel large exposures framework, APRA proposes that existing limits would be amended as follows:

- the large exposure limit will be 25 per cent of an ADI's Tier 1 Capital for exposures to a counterparty or group of connected counterparties. This limit is based on a tighter level of capital compared with APRA's current large exposure limits which use Regulatory Capital (Total Capital);
- the proposed limit for an ADI's exposures to external parties unrelated to the ADI will remain at 25 per cent, but on a Tier 1 Capital basis;
- APRA will remove its current concessionary limit for an ADI's exposure to an unrelated ADI and its subsidiaries, and to foreign parents and their subsidiaries, both of which are currently 50 per cent of Regulatory Capital; and
- APRA proposes not to maintain the requirement that the aggregate exposure to non-deposit-taking subsidiaries is capped at 25 per cent of Regulatory Capital.

New limits

The Basel large exposures framework excludes ADIs' exposures to sovereign governments, central banks and public sector entities (PSEs) that are treated as sovereigns according to risk-based capital requirements. Currently APS 221 excludes exposures to the Australian government, foreign governments and central banks which receive a zero per cent risk weight under Attachment A of APS 112. APRA proposes to implement a large exposure limit of:

- 50 per cent of an ADI's Tier 1 Capital for exposures to governments or central banks which receive a zero per cent risk-weight under Attachment A of APS 112; and
- 25 per cent of an ADI's Tier 1 Capital for all other sovereign exposures.

This recognises the concentration risks inherent in large exposures even to very highly rated sovereign governments.

APRA proposes to exempt from these limits exposures to governments or central banks which are held to meet the LCR. This recognises liquidity risk requirements placed on ADIs and aims to balance large exposure requirements with the need to hold high-quality liquid assets.

APRA proposes to clarify that the definition of government-related entities includes all entities controlled (whether directly or indirectly) by any level of government (including central, state or regional governments), central banks, or PSEs, and includes entities such as state owned enterprises. APRA proposes that the large exposure limit of 25 per cent of an ADI's Tier 1 Capital will apply for exposures to government-related entities. This limit is applied separately to the government or central banks limit of 50 per cent of an ADI's Tier 1 Capital; this reflects that the risks associated with a government-related entity are different to those for a government or central bank as there is discretion to support government-related entities.

3.2 Large exposure limit to G-SIBs

An ADI that holds exposures to a bank designated as a G-SIB exposes itself, and the financial system, to additional risks due to the systemically important nature of these banks. Experience from the global financial crisis demonstrated that the risks arising from systemically important banks should not be disregarded when considering contagion risks.

The Basel large exposures framework includes a 15 per cent limit for exposures between G-SIBs. APRA proposes to require all ADIs to limit their exposures to a G-SIB to 15 per cent of the ADI's Tier 1 Capital. This proposal aims to reduce contagion risk and limit the impacts on ADIs in Australia in the event that losses arise due to the default of a G-SIB.

3.3 Large exposure limit for D-SIBs

APRA proposes to require a bank designated by APRA as a D-SIB to limit its exposures to another bank designated by APRA as a D-SIB to 15 per cent of its Tier 1 Capital.

The Australian banking industry is very highly concentrated: the total assets of the four largest ADIs comprised around 75 per cent of total ADI assets. Contagion risk is further exacerbated by the similarities in business models and exposures amongst Australia's D-SIBs, such that a shock to one D-SIB could very well impact the other D-SIBs, either directly, or through investor perceptions.

APRA considers that a tighter limit between D-SIB exposures would recognise the heightened contagion risk due to the composition of the Australian banking system.

Chapter 4 – Measuring large exposures

Adopting a clear and consistent approach across ADIs in measuring large exposures is a key aspect of APRA's proposals. APRA's revised large exposures framework specifies particular exposure values which are to be adopted in measuring large exposures.

APRA's proposals are in line with the Basel large exposures framework; however they are tailored for Australia in regards to the exposure values for banking book commitments (refer to section 4.1), and covered bond exposures (refer to section 4.4).

4.1 General exposure values

Coverage of exposure values

For purposes of calculating large exposure values, an ADI must include all on-balance sheet exposures and off-balance sheet exposures in both the banking book and trading book, as well as instruments with counterparty credit risk (CCR) under the new draft *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (September 2016) (APS 180).[1]

APRA is proposing specific measurement of types of exposures to ensure a consistent recognition of each type of exposure that an ADI has to a counterparty or to a group of connected counterparties. In summary, for:

- banking book on-balance sheet (non-derivative) assets: measured as accounting value net of specific provisions and value adjustments (unless an ADI has prior agreement from APRA that gross values will be used);
- instruments that give rise to CCR (banking book and trading book OTC derivatives, excluding securities financing transactions (SFTs)): measured as exposure at default as measured under APS 180;
- SFTs: measured as exposure calculated under Attachments H and J of APS 112;
- banking book commitments: measured as drawn on-balance sheet commitments and undrawn off-balance sheet commitments i.e. all committed exposures; and
- long settlement transactions: measured according to APS 180.[2]

Off-balance sheet commitments

The Basel large exposures framework allows off-balance sheet commitments to be measured by applying conversion factors used for the standardised approach to credit risk.

[1] The Discussion Paper on counterparty credit risk for ADIs proposes relocating APRA's existing counterparty credit risk requirements from APS 112 into the new counterparty credit risk prudential standard, APS 180. APRA proposed in that consultation package that revised APS 112 and Attachments E and F of APS 180 will take effect immediately on finalisation of the package.

[2] Long settlement transactions have longer than normal settlement processes, resulting in more substantive risk from extended settlement timeframes. The risks relating to such transactions are captured in APS 180, which implements the Basel Committee's *The standardised approach for measuring counterparty credit risk (March 2014)*.

APRA proposes instead to continue the current approach to measuring off-balance sheet commitments where all committed exposures are included, i.e. this implies a 100 per cent conversion factor is used in converting off-balance sheet commitments into credit equivalent amounts. While lower conversion factors may be appropriate in a diversified portfolio, diversification is not a consideration in measuring large exposures.

4.2 Credit risk mitigation

Currently APS 221 recognises aspects of credit risk mitigation (CRM) in the definition of exposures. APRA proposes to incorporate specific treatment of CRM in line with the Basel large exposures framework. Setting out a common CRM treatment to be applied across exposures will facilitate the measurement of exposures on a more comparable basis.

The Basel large exposures framework recognises the impact of CRM techniques in reducing the exposure values, and also the potential for risks to arise in relation to the CRM provider.

Eligible CRM techniques for large exposure purposes are those which have been allowed under APS 112 e.g. the recognition of eligible collateral, guarantees, and the use of credit derivatives and netting. Forms of collateral that are only permitted under the internal-ratings based approach under APS 113 (such as eligible financial receivables, commercial real estate, and residential real estate), but not APS 112, will not be allowed for large exposure purposes to reduce exposure values. Allowing only the CRM techniques permitted under the standardised approach to credit risk facilitates a consistent and more straightforward approach.

4.3 Trading book positions

The Basel large exposures framework requires an ADI to add trading book and banking book exposures to an individual counterparty in order to determine the ADI's total exposure to that individual counterparty. APRA proposes to adopt this requirement.

In the trading book, positions in financial instruments, such as bonds or equities, are subject to the large exposure limits; however, other exposures, such as currency or commodity concentrations, are not. The draft APS 221 specifies the exposure values to be used for particular types of securities, following the Basel large exposures framework.

Some aspects to note are:

- the proposed measurement of option exposures in the large exposures framework differs from the treatment under risk-based capital requirements as it reflects the scenario of a default in the underlying instrument and the exposure an ADI would have to the options in that instance;
- APRA intends to implement the Basel large exposures framework approach for offsetting long and short positions in the trading book in order to facilitate consistent measurement. That is:
    - for offsetting in the same issue, banks can offset long and short positions to form a net position in a specific issue to calculate the exposures to a particular counterparty;
    - for offsetting in different issues, offsetting is only permitted when the short position is junior to the long position or they have the same seniority;

- the resulting net short positions with an individual counterparty after offsetting do not need to be considered for large exposure purposes; and
- netting of trading book positions against banking book positions is not permitted.

Appendix 1 provides some examples and clarifications on the application of the large exposures framework for exposures involving trading book positions.

4.4 Covered bonds

The Basel large exposures framework applies a concessionary treatment of covered bonds satisfying certain high quality criteria such that a covered bond may be assigned an exposure value of 20 per cent or more of the nominal value of the bank's covered bond holding. APRA does not propose to adopt the concessionary recognition of covered bond exposure values in the Basel large exposures framework. Under the revised APS 221, ADIs will be required to recognise the full nominal value of covered bond holdings as the exposure value, allocating this to the issuer of the covered bonds.

While there are some mitigating factors to the encumbrance and subordination that results for issuing ADIs, and the interruption of depositor preference with covered bonds, these factors are not considered sufficient for the Australian financial system so as to justify a reduction in the exposure value for large exposure purposes.

4.5 Structured vehicles

The Basel large exposures framework specifies the treatment of exposures to structured vehicles, including funds, securitisation vehicles, and other structured finance products. APRA proposes to implement this approach with an exclusion for exposures to RBA repo-eligible residential mortgage-backed securities, such that these exposures are not required to be treated as exposures to structured vehicles.

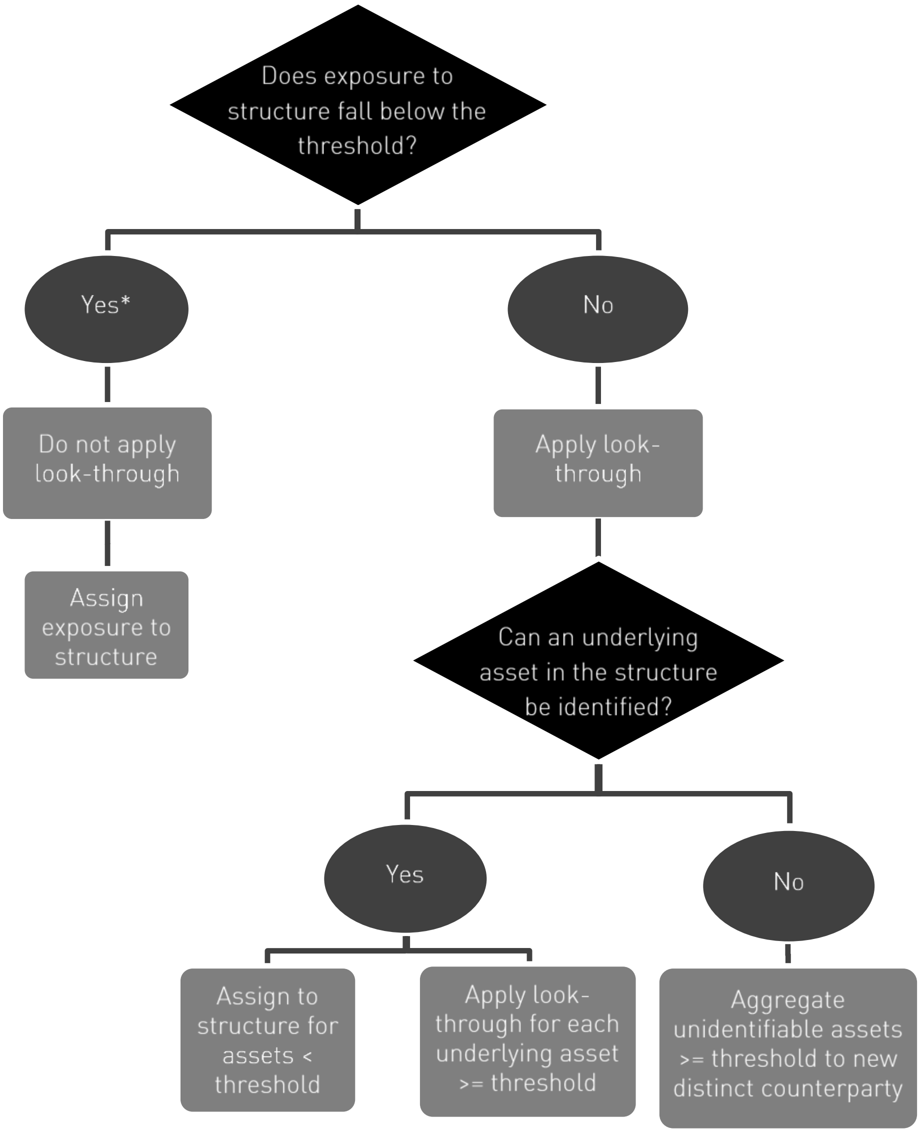
This recognises the need for an ADI to consider the exposures that arise not only from its direct investments in assets, but also from the assets underlying the structured vehicles or vehicles to which it has exposures. APRA's proposals also recognise risks arising from structured vehicles themselves and to any third parties associated with the structured vehicles.

Adopting a threshold and look-through approach

APRA proposes that ADIs use a threshold approach and adopt the 'look-through' concept for recognising large exposures to structured vehicles. This is in line with the Basel large exposures framework and ensures there is greater consistency in the treatment of exposures to structured vehicles across ADIs.

As per Figure 1, where exposures to a structured vehicle are greater than 0.25 per cent of an ADI's Tier 1 Capital ('the threshold'), the ADI is to apply a look through approach which considers whether the underlying asset in the structured vehicle can be identified, to determine to which counterparty the exposure should be assigned.

Figure 1 - Example flowchart for the treatment of exposures to structured vehicles



* Or the ADI can demonstrate this.

Third parties and additional risk factors

The Basel large exposures framework recognises that there may be third parties that constitute an additional risk to the ADI which arise from the existence of the structured vehicle itself, and not from the underlying assets of the structured vehicle. APRA proposes to also incorporate this recognition.

Under the proposals, ADIs will need to consider the potential for third parties, such as fund managers, originators, liquidity or credit protection providers, to contribute to additional risks for the ADI. For example in the case where a liquidity provider for asset backed commercial paper conduits or structured investment vehicles is the additional risk factor across structured vehicles, the exposure value to the liquidity provider is the sum of all investments in structured vehicles with this liquidity provider.

ADIs will need to add their exposures in the structured vehicles associated with a third party considered to be a shared additional risk factor to other exposures (such as a loan) that the ADI has to that third party; where there are multiple third parties that act as drivers of additional risk, ADIs will also be required to assign the exposure in the structured vehicles to each third party. This must occur when there is risk to the exposures in the structured vehicles associated with the third party when the third party defaults on a direct exposure to the ADI, or when there is risk to a direct exposure to the third party if the third party were to default in its role in the structured vehicles.

4.6 Non-qualifying central counterparties and clearing activity exposures

The Basel large exposure framework specifies exposure values for non-qualifying CCPs as the sum of clearing exposures and non-clearing exposures, with specific exposure values to be used for each type of clearing activity to facilitate consistency in measuring the aggregate exposure values subject to the large exposure limits. APRA proposes to implement this approach.

APRA does not propose to apply the concept of connected counterparties to exposures to CCPs (both QCCPs and non-qualifying CCPs) that relate to clearing activities. However, ADIs will need to consider non-clearing exposures to CCPs and determine whether the CCP is connected to other counterparties.

To determine the counterparty in which to assign exposures when an ADI acts as a clearing member to a CCP or is a client of a clearing member, ADIs should refer to the requirements under APS 180.

Chapter 5 – Prior consultation, approval and notification requirements

5.1 Prior consultation for committing to any large exposures

APRA intends to maintain the current requirement in APS 221 for ADIs to consult with APRA prior to committing to proposed large exposures.

APRA will retain the ability to determine a higher consultation threshold or waive, in writing, the prior consultation requirements for ADIs on a case-by-case basis where this is considered to be appropriate in the context of the ADI's credit risk management framework.

5.2 Approval for exceeding large exposure limits

Where an ADI proposes to undertake exposures which will result in the ADI exceeding large exposure limits, the revised APS 221 continues to allow an ADI to request approval from APRA.

APRA recognises that the revisions to the level of capital used in large exposure limits and the proposed change to numeric limits will have a varied effect on ADIs. The ability for ADIs to request approval for exceeding large exposure limits recognises the potential need to exceed large exposure limits under specific circumstances.

APRA's approval of a large exposure should not be interpreted as endorsement of a particular credit; it is the ADI's responsibility to ensure it has conducted proper credit assessment. The approval requirements in the revised APS 221 have been amended to emphasise an ADI's responsibility to undertake and provide a comprehensive assessment of the concentration risks involved with the proposed exposures which exceed large exposure limits. As part of this assessment, an ADI is expected to demonstrate that undertaking the proposed exposure is consistent with its large exposures and risk concentrations policy in terms of the circumstances in which limits may be exceeded and the authority and processes required for approving such excesses.

APRA will have regard to the circumstances in which the approval is being requested e.g. whether the approval is requested for a finite period of time, if the proposed exposure arises due to liquidity or asset management as part of its role as a service provider etc. APRA may determine higher Prudential Capital Requirements to reflect additional risks associated with proposed large exposures or to reflect an ADI being excessively exposed to a significant level of risk concentration, or direct an ADI to take measures to reduce its level of risk concentration.

5.3 Notification requirements

APRA proposes to retain notification requirements in APS 221 such that:

- ADIs are required to notify APRA of any breach of the large exposure limits (or other specific limits required by APRA), and provide details on how the breach arose and the remedial actions taken or intended to be taken; and
- when an ADI has concerns that any large exposures or risk concentrations have the potential to impact materially on its capital adequacy, it must notify APRA and advise APRA of the proposed measures that will be taken.

5.4 Treatment of previous exemptions and alternative approaches

There are some ADIs, such as service providers, which may have large exposures by virtue of managing liquidity or asset positions as part of their business strategy and which maintain a critical role in markets. Other ADIs may have exemptions granted by APRA under the current large exposure requirements.

With the proposed revisions to the large exposures framework, APRA considers it timely to reconsider the ongoing relevance and suitability of existing large exposure exemptions and the need for an alternative approach for certain ADIs. APRA is proposing that ADIs will need to re-apply for any exemptions from the revised large exposures framework regardless of existing exemptions held.

APRA requests views on the need for an alternative approach for some ADIs, such as service providers, and how large exposure limits may be applied to such ADIs while balancing the need for a strengthened supervisory framework for large exposures and reduced system-wide contagion risk.

Chapter 6 – Reporting of large exposures

6.1 Reporting requirements for large exposures

Currently APRA requires reporting on ARF 221.0 of an ADI's 10 largest exposures and all those exposures that are greater than or equal to 10 per cent of Regulatory Capital (as defined under APS 001). APRA proposes that the large exposure reporting requirements be expanded to reflect the need for greater information on large exposures to be provided, which is in line with the Basel large exposures framework. The proposed reporting will assist APRA prudential supervisors in assessing the concentration risks of ADIs.

Proposed reporting will include exposures to individual counterparties and groups of connected counterparties for:

- all large exposures (i.e. exposures greater than or equal to 10 per cent of an ADI's Tier 1 Capital). These exposure values will include the effect of credit risk mitigation;
- all exposures without the effect of credit risk mitigation being taken into account which are greater than or equal to 10 per cent of Tier 1 Capital;
- certain exposures which have been excluded from large exposure requirements which are greater than or equal to 10 per cent of Tier 1 Capital (refer to section 6.2);
- the largest 20 exposures measured as specified for large exposure purposes, regardless of the size of the exposures as a proportion of the ADI's Tier 1 Capital.

The instruction guide for ARF 221.0 reflects amendments to the securitisation deconsolidation principle to align with revisions to *Prudential Standard APS 120 Securitisation* (APS 120), in which the election to treat securitised assets as on-balance sheet assets has been removed as a consequence of APS 120 accommodating funding-only securitisations.

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

6.2 Reporting of excluded exposures

Under the proposed reporting of large exposures, certain exposures which have been excluded from being subject to large exposure limits will be required to be reported separately to the largest 20 exposures. This aims to ensure that there is a consistent approach applied by ADIs and there is visibility on the exposures subject to large exposure limits as well as those which are not subject to the large exposure limits, but remain part of an ADI's large exposures framework (and are considered in the ADI's large exposures and risk concentrations policy).

This will result in the largest 20 exposures reported including only those exposures which are subject to the large exposure limits. The excluded exposures which will be required to be reported separately are:

- exposures to governments or central banks held for LCR purposes; and

- exposures to QCCPs relating to clearing activities.

Those exposure amounts which have been deducted from an ADI's Regulatory Capital under APS 111, exposures to the extent that they have been written off, exposures to the Australian Government or any Australian dollar exposure to the RBA and intra-day interbank exposures, will not be required to be reported.

Appendix 1 – Examples involving trading book positions

Measuring trading book exposures

This Attachment provides some examples and clarifications on the proposed measurement of trading book positions for large exposures.

Options

A representation of the exposure value for options is depicted in the following table where MV refers to the market value and X refers to the strike price.

Exposure	Call	Put
Long	MV	- (X – MV)
Short	- MV	X - MV

While the market risk loss on the default of a counterparty could be very large, such as in the case of a sold call when the price of the underlying rises, the large exposures framework is instead focused on the exposures to the counterparty (such as the seller) on default. For the example of a sold call, when the underlying price is zero, the exposure (at default) would be negative as a profit has been made from selling an option which has no value to the buyer.

Conversion into transaction legs

For instruments such as swaps, futures, forwards and credit derivatives, the exposure values to be used are those decomposed transaction components determined under *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116) which are not excluded from large exposure requirements.

An example of the treatment for the decomposed transaction legs of a future, is where a future on a stock is decomposed into a long position in the stock and a short position in a risk-free interest rate exposure in the respective funding currency. In this situation, the long position in the stock is subject to the Basel large exposures framework, whereas the risk-free interest rate exposure should not be included.

Credit derivatives representing sold protection

For credit derivatives representing sold protection, the exposure to the referenced name is the amount due in the case that the referenced name triggers the instrument, less the absolute market value of the credit protection (paragraph 11 of Attachment A of draft APS 221).

- If the market value of the credit derivative is positive for the protection seller, this positive market value needs to be added to the exposure of the protection seller to the protection buyer (due to counterparty credit risk). An example of where this may occur is if the present value of the already agreed, but not yet paid, periodic premiums exceeds the absolute market value of the credit protection.
- If the credit derivative has a negative marked-to-market value, subtracting the absolute value of the credit derivative ensures there is no double counting of the current marked-to-market loss.

Offsetting in different issues

Seniority of securities

The Basel large exposures framework allows ADIs to allocate securities into broad categories of seniority to determine the relative seniority of positions, for example as equity, subordinated debt, and senior debt. ADIs should apply such categorisation consistently across their whole portfolio when it is used. Where the allocation of securities to categories of seniority is determined by ADIs as not feasible, ADIs must not recognise offsetting of long and short positions in different issues relating to the same counterparty in determining their large exposure values.

An example where an ADI may offset positions in different issues from the same counterparty when the short position is junior to, or ranks pari passu with, the long position, is offsetting of a long debt position with a short equity position. Conversely, offsetting a long equity position with a short debt position would not be allowed under the revised large exposures framework.

Credit default swaps

Ordinarily, under the proposed treatment for CRM for large exposures, a reduction in exposure to an original counterparty would result in a new exposure (equal to the amount that the exposure value to the original counterparty was reduced) being assigned to the credit protection provider.

In line with the Basel large exposures framework, APRA proposes a different treatment for positions hedged by credit derivatives where the credit protection is in the form of a credit default swap (CDS). Provided the CDS provider, or the entity to which the credit protection applies, is not a financial institution (as defined under *Prudential Standard APS 001 Definitions* (APS 001), then the exposure amount to be assigned to the CDS provider is the CCR exposure value which is calculated under APS 112 (paragraph 17(b) of Attachment A of draft APS 221).

For an institution to be exposed to a significant loss where a CDS is involved, it is likely that both the CDS provider and the institution would need to default i.e. concerns arise when there is a 'double' default. The proposed treatment for CDS' recognises that the likelihood of a double default is considered to be lower when a non-financial counterparty is involved as compared to when two financial institutions are involved.

Example involving offsetting

The following example has been included to illustrate possible interactions between trades which an ADI would consider in measuring exposure values involving trading book positions. Consider an ADI with five trades:

- bought credit default swap (trading book): this has a reference entity, 'ABC', and a derivative counterparty, 'XYZ' (this is similar to a short position in ABC, with a CCR exposure to XYZ);
- short equities position (trading book): this has reference entity ABC;
- bought bond position (trading book): this has a reference entity XYZ;
- bought interest rate swap (banking book): this has a derivative counterparty XYZ, and a CCR exposure to XYZ; and
- loan (banking book): this has reference entity ABC (this is similar to a long position in ABC).

Paragraph 1(b) of Attachment A of draft APS 221 allows netting of the counterparty credit risk to XYZ across the trading book and banking book (e.g. between the trading book credit default swap and the banking book interest rate swap). For this counterparty credit risk exposure, both current exposure and potential future exposure would be calculated based on the standardised approach to counterparty credit risk (SA-CCR); this is different to both the accounting value (current marked-to-market value) and face value (e.g. notional value of swaps) of the positions. From paragraph 8 of Attachment A of draft APS 221, the ADI would add its XYZ exposure in the trading book from the bought bond to its XYZ counterparty credit risk exposure value to obtain its total exposure to XYZ.

For the exposure to ABC, paragraph 18 of Attachment A of draft APS 221 would not allow netting of short credit exposures in the trading book with positions in the banking book. For example, the short equity position and bought credit default swap in the trading book on ABC cannot be used to offset the ABC banking book loan.

In summary, from paragraph 8 of Attachment A of draft APS 221, trading book positions are additive to other positions (if positive) and from paragraph 18 of Attachment A of draft APS 221, if the trading book positions are short, then they cannot be used to offset banking book exposures i.e. the exposure to ABC would relate to the banking book loan as no offsetting with trading book positions is allowed.

Appendix 2 – Policy options and estimated comparative net benefits

APRA has considered several options in developing proposed revisions to its large exposure requirements in APS 221 and the associated reporting standard, reporting forms and instruction guides. Three policy options and the potential costs and net benefits are addressed below. APRA intends to incorporate feedback from industry on the policy options and provide estimated comparative net benefits in a Response Paper on revisions to APS 221 when it finalises the large exposure requirements.

Information provided in response to APRA's request for cost-benefit analysis information (see section 1.6) 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.

Options	Approach
Option 1: Status quo	Maintain APRA's existing prudential requirements for large exposures
Option 2: Full implementation	Fully implement the Basel large exposures framework with no adjustments
Option 3: Implementation with some adjustments	Implement the Basel large exposures framework with some adjustments for Australia and certain ADIs

Option 1: Status quo

The first option is to maintain the status quo where APS 221 and the associated reporting standard, reporting forms and instruction guides are unchanged. The management of large exposures and concentration risks would continue to be addressed through supervision of ADIs in credit risk assessments, prudential reviews and regular supervisory liaison based on the current APS 221. Maintaining the *status quo* would not cause any immediate additional compliance costs for ADIs, however if APRA's proposals for revisions to the large exposure requirements are not adopted, there are a range of indirect costs and implications that may result:

- Inconsistencies within Australia and across jurisdictions – variable treatment of large exposures within Australia and across different jurisdictions would result in inconsistent approaches to managing large exposures, there would also be continued uncertainty in the concentration risks affecting ADIs. The lack of transparency in the measurement of large exposures may also misrepresent the riskiness of an ADI to investors resulting in impacts on foreign investor confidence when providing funding to Australian ADIs;

- Insufficient protection from large losses – APRA's current large exposure requirements were developed prior to the introduction of certain types of exposures and counterparties that have since grown in prevalence. Significant developments in the financial system in recent years include: greater focus on higher quality capital; and the introduction of certain assets such as covered bonds. If large exposure requirements do not incorporate the now recognised need in these areas there could be insufficient protection from large losses.
- Potential for system-wide contagion risk – a key lesson from the global financial crisis has been the potential for material losses in a systemically important bank to compromise the viability of their direct counterparties or connected counterparties. This has flow-on effects to financial stability due to the importance of such entities to the economies they operate in. Current large exposure requirements do not recognise the potential for greater contagion risks from systemically important banks.

Indirect costs are not easily quantifiable; there could be moderate to substantial costs when there is insufficient protection from large losses and contagion risk causes flow-on effects in the economy. The range of implications also depends on the circumstances of an ADI, including the counterparties to which an ADI has exposures, the exposures which an ADI currently recognises, and an ADI's current methodology in measuring large exposures.

The Basel large exposures framework is recognised as an international benchmark and it allows industry to understand and place reliance on the standardised nature of regulation to which an ADI is subjected. When jurisdictions take an approach that deviates significantly from international standards, ADIs may increasingly find themselves operating in a less transparent environment which can create opportunities that are not in their, or the broader economies', best interests. A lack of compliance with international frameworks may also adversely affect the views of analysts, credit ratings agencies, investors, banks and other stakeholders about Australian ADIs.

Failure to implement the Basel standards may adversely affect Australia's standing globally, given the commitments by the Group of 20 (G20) members to implement Basel standards in a full, timely and consistent manner. Australia's reputation as a member of the Basel Committee, Financial Stability Board and G20, founded on a long-standing commitment to adhere to international standards, could be diminished, limiting Australia's capacity to influence these developments in the future.

APRA believes the *status quo* will result in a negative net impact as the costs associated with this option would become more significant at times, such as during a financial crisis, when minimum standards on concentration risk are most needed. Furthermore, if Australia's large exposure requirements are viewed by stakeholders as falling behind international standards, and as incomparable with banks in other jurisdictions, the net impacts of the *status quo* will be increasingly negative.

Option 2: Full implementation

A second option is for APS 221 and the associated reporting standard, reporting forms and instruction guides to be revised to fully incorporate the Basel large exposures framework. ADIs would be required to comply with the new requirements by 1 January 2019. This timeframe would allow industry sufficient time to make changes to recognise the final revised APS 221 and the associated reporting standard, reporting forms and instruction guides.

Full implementation would: address inconsistencies within Australia and between jurisdictions (to the extent that other jurisdictions adopt the Basel large exposure requirements) on the measurement of large exposure values; mitigate insufficient protection from large losses; and recognise the potential for system-wide contagion risk.

APRA expects that full implementation would result in compliance costs that are similar to those set out under the third option, but the second option would have a higher burden on ADIs as it would not flexibly account for Australian conditions nor accommodate certain types of ADIs as the third option does.

Option 3: Implementation with some adjustments

A third option is to implement the Basel large exposures framework in APS 221 and the associated reporting standard, reporting forms and instruction guides with adjustments for Australia and for certain ADIs. ADIs would be required to comply with the new requirements by 1 January 2019. This timeframe would allow industry sufficient time to make changes to recognise the final revised APS 221 and the associated reporting standard, reporting forms and instruction guides.

Given the third option is a change to the *status quo*, APRA anticipates that there will be additional compliance costs for ADIs:

- some ADIs will need to adjust their exposures to meet revised large exposure limits to ensure excessive concentration risks are identified and appropriately limited. There will be costs associated with identifying counterparties and groups of connected counterparties, and assessing and measuring large exposures according to the specified methodologies;
- there would also be increased risk management, compliance and operational costs to meet new requirements, including costs associated with changes to policies, processes, systems and controls to reflect the revised large exposure requirements; and
- there would be an initial increase in costs to amend compliance procedures for changes to reporting requirements and sourcing any additional data required for large exposure reporting forms. However APRA expects that these costs would be at the margin or minimal as ADIs would most likely be collecting and monitoring such data at present.

Under the third option APRA makes targeted adjustments that are suitable for Australia and certain ADIs as outlined in this Discussion Paper. Allowing adjustments for Australia and for certain ADIs provides for a cohesive prudential approach which aligns more closely with APRA's broader prudential framework for supervision of ADIs. For example, adopting a more prudent approach for the value of covered bond exposures, which have a different purpose in the Australian economy compared with other jurisdictions. APRA is also seeking responses on the treatment of previous exemptions and alternative approaches (see section 5.4), for example for smaller ADIs or service providers which have a unique role in liquidity management for smaller ADIs in Australia.

A risk of not making adjustments for Australia is that there are aspects in limits, exclusions from exposures, and the measurement of exposures which do not appropriately account for the design of the Australian banking industry and the counterparties to which ADIs interact; an example being the introduction of limits involving systemically important banks, or the exclusion of exposures to governments or central banks held for LCR purposes.

There are broader implications of not adopting the third option including the potential for the failure of a counterparty or group of connected counterparties to the extent that large losses impact the solvency of an ADI, and cause repercussions in terms of reputational risk and uncertainty in the banking and financial sector. In the extreme, and particularly where systemically important banks are involved, impacts may be felt throughout the Australian economy, affecting confidence in the economy and foreign investor willingness to invest in Australia.

Overall, APRA believes the third option will have less impact on ADIs compared with the second option due to the benefits from revised requirements outweighing some increases in compliance costs to ADIs which would likely be short-term in nature. The third option will ensure that Australia maintains its reputation for compliance with international best practice while enabling a flexible regime for Australia and certain ADIs where appropriate, so that Australian ADIs are able to remain competitive with international peers and operate in a financial system that is better safeguarded from excessive concentration risk.

Glossary

ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 001	*Prudential Standard APS 001 Definitions*
APS 110	*Prudential Standard APS 110 Capital Adequacy*
APS 111	*Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*
APS 112	*Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*
APS 113	*Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*
APS 116	*Prudential Standard APS 116 Capital Adequacy: Market Risk*
APS 120	*Prudential Standard APS 120 Securitisation*
APS 221	*Prudential Standard APS 221 Large Exposures*
APS 222	*Prudential Standard APS 222 Associations with Related Entities*
Basel Committee	Basel Committee on Banking Supervision
Basel large exposures framework	*Standards: Supervisory framework for measuring and controlling large exposures*, April 2014
CET1 Capital	Common Equity Tier 1 Capital
CPS 220	*Prudential Standard CPS 220 Risk Management*

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