



23 April 2018

TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

RESPONSE TO SUBMISSIONS — COUNTERPARTY CREDIT RISK FOR ADIs

On 3 August 2017, the Australian Prudential Regulation Authority (APRA) released a discussion paper *Counterparty credit risk for ADIs* (2017 discussion paper) setting out responses to submissions to the 2016 discussion paper *Counterparty credit risk for ADIs* (2016 discussion paper) and commencing a further consultation on specific aspects of the proposed framework. The 2016 discussion paper proposed revisions to the prudential framework for counterparty credit risk for authorised deposit-taking institutions (ADIs) that incorporated amendments to the Basel Committee on Banking Supervision (Basel Committee) framework for counterparty credit risk. The 2017 discussion paper modified a number of APRA's earlier proposals after taking into consideration issues raised in submissions. It was also accompanied by draft prudential and reporting standards.

The key aspect of the 2017 discussion paper and the topic of further consultation was a series of revisions to the standardised approach for measuring counterparty credit risk exposures (SA-CCR). While the 2016 discussion paper proposed to apply the SA-CCR to all ADIs that transact over-the-counter (OTC) derivatives, exchange-traded derivatives and long settlement transactions, views were also sought on an alternative simple approach for ADIs with immaterial levels of counterparty credit risk exposure. APRA proposed the continued use of the current exposure method (CEM), subject to appropriate recalibration, as an appropriate, simple alternative. The paper also sought comments on proposed reporting requirements for counterparty credit risk.

APRA received a total of seven submissions on the 2017 discussion paper. Submissions did not raise issues with APRA's proposed adoption of the adjusted CEM, hence APRA will adopt this simplified approach for ADIs with immaterial counterparty credit risk, which will be the approach for the majority of ADIs. Otherwise, issues raised were of a general nature with some covering technical aspects of the proposals. This response letter covers the material issues raised in those submissions and some matters of clarification (refer to Attachment A).

In addition, APRA has made a number of other changes to the final standards being released today, including incorporating additional material from Frequently Asked Questions (FAQs) published by the Basel Committee (refer to Attachment B).

Final standards

Accompanying this Response to Submissions letter are the final versions of the following standards:

- *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112);
- *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180);
- *Reporting Standard ARS 112.2 Standardised Credit Risk - Off-balance Sheet Exposures*;

- *Reporting Standard ARS 118.1 Other Off-balance Sheet Exposures; and*
- *Reporting Standard ARS 180.0 Counterparty Credit Risk (including Reporting Form ARF 226: Margining and risk mitigation for non-centrally cleared derivatives).*

Implementation timeline

To allow ADIs time to make the necessary changes, in order to meet the new and revised requirements for counterparty credit risk, the standards will commence on 1 July 2019.

The final revised prudential and reporting standards are available at:

<http://www.apra.gov.au/adi/PrudentialFramework/Pages/adi-consultation-packages.aspx>.

Yours sincerely,



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ATTACHMENT A

RESPONSE TO SUBMISSIONS

Use of SA-CCR for calculations under prudential standards other than APS 180

One submission queried whether an ADI that is required to apply the SA-CCR under APS 180 should also use that method across all other prudential standards for the purpose of calculating its counterparty credit risk.

APRA notes that an ADI should use the same approach for measuring its counterparty credit risk for all prudential and reporting standards unless a standard specifically states otherwise.

Basis risk

One submission queried whether basis risk hedging should be broken down into maturity buckets, and the approach to be used if basis risk is categorised by maturity bucket.

APRA notes that, consistent with the Basel Committee's framework, basis risk should be broken down into relevant maturity buckets. APRA has amended Attachment D of APS 180 to reflect this.

Mandatory breaks

Two submissions queried APRA's proposed treatment of transactions with mandatory breaks. It was requested that APRA allow ADIs to treat transactions with mandatory breaks such that the contractual maturity date is the mandatory break date given such a break is considered a contractual maturity for parties to the transaction.

In the 2017 discussion paper, APRA indicated that a transaction with a mandatory break clause should not be treated in the same manner as a transaction with a shorter contractual maturity. The discussion paper also noted that given there is no certainty that a break will actually occur in such transactions, hence the transaction's maturity should be set to the latest possible maturity date at which the transaction may still be active, measured in years.

After further consideration of this issue, and acknowledging that under certain circumstances a transaction with a mandatory break is akin to contractual maturity, APRA has amended APS 180 to allow transactions with mandatory breaks to be treated as though the maturity date is the mandatory break date provided the criteria in paragraph 42(e) of Attachment D to APS 180 are met.

Reporting by foreign ADIs

Some submissions sought guidance on proposed margin reporting requirements for foreign ADIs, noting that many foreign ADIs consolidate transactions under their home office thereby making it difficult to report country-specific margins.

APRA notes the operational difficulties some foreign ADIs could face in this respect and will therefore exempt foreign ADIs from the margin reporting requirements. Locally incorporated subsidiaries with a foreign parent will be required to comply with the margin reporting requirements.

Scope and coverage of reporting standards

One submission noted that, with the introduction of the new *Reporting Form ARF 180.2 Counterparty Credit Risk and CVA Risk* (ARF 180.2) details of off-balance sheet market-related exposures will be reported on two forms, being the ARF 113-series forms and ARF 180.2. It was argued this could create confusion when aggregating risk-weighted amounts to arrive at total counterparty credit risk for individual ADIs.

APRA notes that while there is some overlap between the two forms, ARF 180.2 provides valuable granularity for the purpose of capturing specific data on derivative and securities financing transactions (SFTs) that is not available under the ARF 113-series forms. Hence, reporting on both sets of forms has been maintained in this final release.

Composite contracts

One submission argued that ADIs should be allowed to decompose contracts into discrete instruments for the purposes of the SA-CCR capital calculation framework. Further, it was requested that when no legal netting agreement is in place to support a single contract, that ADIs be allowed to treat constituent instruments of such contracts as being within their own distinct netting set.

For non-linear products, the Basel Committee FAQ on option positions with differing payoffs addresses this issue directly (see Attachment B). For linear products, APRA's view remains as previously indicated; that is, linear products should not be decomposed into discrete instruments for a number of reasons, including:

- such treatment is inconsistent with the intent of the SA-CCR rules;
- unlike non-linear products where decomposition assists in determining the appropriate supervisory delta (as described in APS 180), such treatment is unnecessary for linear products whose delta calculation is relatively straight-forward; and
- allowing ADIs the option to decompose linear trades could lead to undue RWA-variability between ADIs.

Long settlement transactions and unsettled and failed transactions

One submission requested clarity on the treatment of long settlement transactions and how it would interact with the existing unsettled and failed transactions framework in Attachment D of APS 112.

APRA notes that APS 112 refers to unsettled and failed transactions with a normal settlement period. Long settlement transactions may, however, also remain unsettled after their due delivery dates. APS 112 has been amended to clarify that the requirements for treatment of unsettled and failed transactions also applies to long settlement transactions.

ATTACHMENT B

BASEL COMMITTEE FAQs – CLARIFICATION OF CERTAIN MATTERS

The Basel Committee has recently finalised a number of frequently asked questions (FAQs) that address certain operational and interpretation issues in relation to the SA-CCR. In some cases, the FAQs address matters that have been separately raised by industry with APRA and provide clarity on the appropriate approach. APRA has incorporated relevant aspects of these FAQs into the final APS 180 as noted below.

Interest rate options in a negative interest rate environment

This addresses issues raised by industry on calculating the existing supervisory delta formulae in a negative interest rate environment. The FAQ clarifies the standard adjustments to the formulae to allow their application in a negative interest rate environment. Refer to Attachment D, APS 180.

Settled-to-market versus collateralised-to-market centrally cleared transactions

This clarification sets out the conditions under which a bank may treat payment of variation margin as a settlement payment, rather than the lodgement of collateral. It also outlines the differential treatment between settled-to-market and collateralised-to-market transactions. Refer to Attachment B, APS 180.

Option positions with different payoffs

Some ADIs have questioned how to treat options with different payoffs as well as digital options. The FAQ provides clarification on the treatment of these types of options. It also provides guidance on the decomposition of option positions for the purposes of the SA-CCR calculation. APRA has incorporated this treatment in Attachment D of APS 180. APRA will also allow an ADI to adopt a different treatment in relation to digital options, subject to agreement by APRA of the proposed treatment.

Sold credit-protection positions and nth-to-default credit derivatives

This clarification includes additional details on the treatment of credit derivatives. APRA has amended Attachment D of APS 180 to reflect the amended treatment.

Transactions where there is collateral taken outside of a netting set but otherwise available to offset derivative losses in the event of default

This clarification deals with the issue of how banks should recognise eligible collateral provided by clients outside netting sets. APRA has incorporated this treatment in Attachment D, APS 180.